No. 609.

In the Supreme Court of the United States.

OCTOBER TERM, 1921.

CONTINENTAL INSURANCE COMPANY

AND

FIDELITY-PHENIX FIRE INSURANCE COMPANY OF NEW YORK,

Appellants,

v.

READING COMPANY, *et al.*,

Appellees.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF PENNSYLVANIA.

BRIEF FOR APPELLANTS.

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Statement of the Case.

This is an appeal from a decree of the United States District Court for the Eastern District of Pennsylvania which approved a plan for the dissolution of the combination held illegal by this Court in *United States* v. *Reading Company, et al.,* 253 U. S. 26. So far as the plan relates to the disposition of the shares of stock of the Philadelphia & Reading Coal and Iron Company, the appellants

contend that it is inequitable and in derogation of their rights as the holders of common stock of the Reading Company.

For convenience, we shall hereinafter refer to the Philadelphia & Reading Railway Company as the Railway Company, and to the Philadelphia & Reading Coal and Iron Company as the Coal Company.

In *United States* v. *Reading Company, et al.*, 253 U. S. 26, this Court held that the ownership and control by the Reading Company of the stock of the Railway Company and of the Coal Company, was unlawful, and directed the District Court to make

> "such provision for the disposition of the shares of stock and bonds and other property of the various companies, held by the Reading Company, as may be necessary to establish the entire independence from that company and from each other"

of the Railway Company and the Coal Company. The decree on mandate of the District Court required the defendants to submit a plan for the dissolution of the unlawful combination (R. 36). Pursuant thereto, the defendants Reading Company, the Railway Company, and the Coal Company submitted a plan which, omitting such features as were subsequently eliminated or modified and which are not in issue in this Court, contained proposals as follows:

> (1) The assumption by the Reading Company of, and the agreement of the Reading Company to save the Coal Company and its property harmless from, the General Mortgage and the $96,524,000 principal amount of general mortgage 4% bonds, now the joint obligation of the two companies;
>
> (2) The payment by the Coal Company to the Reading Company of $10,000,000 in cash, or current assets at market value, and $25,000,000 in new 4% mortgage bonds of the Coal Company;
>
> (3) The delivery of general releases as between

the Coal Company and the Reading Company, including a release of the Coal Company's liability of $69,357,017.99 to the Reading Company;

(4) * * * *

(5) The creation of a new corporation to acquire the stock of the Coal Company or the interest of the Reading Company therein; such new corporation to issue 1,400,000 shares of no par value stock; such new stock to "be sold to the stockholders of the Reading Company, preferred and common, share and share alike, for $5,600,000, or $2.00 for each share of Reading Stock", with provisions designed to prevent common control of the Coal Company and the Railway Company.

(6) The merging of the Railway Company into the Reading Company which is to retain its name and charter (R. 40-45).

The Court ordered that the plan as originally submitted be filed and be "open to the inspection of all stockholders of the said companies" (R. 47). Thereafter, a number of petitions to intervene were filed. These were on behalf of the Continental Insurance Company and the Fidelity-Phenix Fire Insurance Company of New York, holding 8,400 shares of common stock (R. 52), the Prosser Committee representing upwards of 450,000 shares of common stock, also appellants herein (R. 102), Frances T. Ingraham holding 11,050 shares of common stock (R. 120), the Iselin Committee representing 207,397 shares of preferred stock (R. 131), the New York Central Railroad Company holding 406,600 shares of preferred and 197,050 shares of common stock (R. 140), the Baltimore & Ohio Railroad Company holding 406,600 shares of preferred and 200,050 shares of common stock (R. 142), William B. Kurtz and Madge Fulton Kurtz holding together 5,100 shares of preferred stock, the Penn Mutual Life Insurance Company, The Girard Avenue Title and Trust Company, and the Pennsylvania Company for Insurances on Lives and Grant-

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ing Annuities, each holding general mortgage bonds of the Reading Company and the Coal Company (R. 144-147), and Joseph E. Widener holding 100,000 shares of common stock (R. 148).

No objection to the intervention was interposed by the Reading Company, the Government or any other party. Leave to intervene as parties defendant was duly granted to these appellants and others (R. 203) and an order entered (R. 205) setting down for argument, among others, the following questions:

1. (*a*) "Whether the sale provided for in paragraph Five of the Reading Plan is such a disposition of the interest of Reading Company in the stock of The Philadelphia & Reading Coal & Iron Company as accomplishes the express purpose of the mandate of the Supreme Court of the United States requiring disposition by Reading Company of such stock because the holding of it has been and would be unlawful;

   (*b*) and if the mandate is thereby complied with, whether such disposition confers upon any one class of stockholders of Reading Company any benefit to the prejudice of the legal rights of any other class of stockholders" (R. 206).

Argument was duly had. The plan was modified (R. 210-212) in certain aspects not now material, and as so modified (R. 274-277) approved in an opinion of the Court below (273 Fed. 848; R. 278), and by a corresponding decree (R. 287). The District Court was constituted of two Circuit Judges and a District Judge under the authority of the Expediting Act, 32 Stat. 823, c. 544; 36 Stat. 854, c. 428; and as provided by the same Act, the case comes directly to this Court.

The Facts.

The capital stock of the Reading Company outstanding consists of 2,800,000 shares of the par value of $50 each ($140,000,000), of which

560,000	shares ($28,000,000) are non-cumulative 4% first preferred stock;
840,000	shares ($42,000,000) are non-cumulative 4% second preferred stock; and
1,400,000	shares ($70,000,000) are common stock.

Under the proposed plan, all holders of shares of the Reading Company, whether preferred or common, are given equal rights to acquire the shares of the new corporation for $2.00 for each share of Reading stock. The new corporation is to issue 1,400,000 shares of no par value and is to acquire at first the right, title and interest of the Reading Company in and to all of the stock of the Coal Company and upon the discharge of the General Mortgage, the stock of the Coal Company itself. (The new corporation will be hereinafter referred to as the New Coal Company, and the right, title and interest of the Reading Company in and to the stock of the Coal Company as the stock of the Coal Company.) A holder, therefore, of two shares of Reading stock, whether preferred or common, on paying $4.00 would have a right to one share of stock of the New Coal Company. To avail himself of the right conferred, however, the Reading Company stockholder must make an affidavit to the effect that he does not own any shares of the capital stock of the Reading Company, and is not acting for or on behalf of any stockholder of the Reading Company, or in concert, agreement or understanding with any other person for the control of the New Coal Company in the interest of the Reading Company, but in his own behalf in good faith. (R. 305). To obtain the New Coal Company stock,

therefore, a Reading stockholder must dispose of his present Reading stock. He may, however, retain his Reading stock and sell his "right" to acquire the New Coal Company stock to some outsider, who may make the required affidavit. The right to obtain the New Coal Company stock is assignable. In the normal course of events, it may be assumed that Reading stockholders would prefer to sell their assignable rights in the New Coal Company stock. In this manner the New Coal Company stock would soon pass into the hands of persons independent of and unconnected with the Reading and the Railway Companies.

Neither the Reading Company nor the Coal Company is to be dissolved or liquidated. Both will continue in business. Simply, Coal Company stock is to be transferred to the New Coal Company whose shares in turn are to be distributed.

The Distribution of Valuable Rights to Reading Stockholders.

The assignable "rights" thus to be distributed to Reading stockholders are very valuable. Such rights have been selling on the market since the plan was announced. The record discloses that they have been sold as high as $20.00 for the right pertaining to each Reading share, and as low as $13.50 (R. 128). On this basis the two shareholders who together own 813,200 shares of preferred stock (R. 140, 142) would receive rights on their preferred stock alone of a minimum market value of $10,978,200.

The market value of the assignable rights to be distributed, reflects to a certain degree, the value of the Coal Company assets and business whose stock is to be distributed. If the intercompany liabilities which are to be released according to the plan (such as that for the capital stock of the Coal Company, $8,000,000, and its debt to the Reading Company of $69,357,017.99) are

eliminated, the balance sheet of the Coal Company for December 31, 1920, deducting every other item appearing on the liability side, shows a net worth remaining of $103,042,447.47 (R. 198, Exhibit F of Reading answer).

This represents assets of $111,766,454.01, less liabilities of $8,724,007.54. Of this net worth of $103,042,447.47, $6,506,955.26 is in Liberty Bonds and current assets alone total $26,803,427.37 of which $8,245,174.27 is in cash.

The plan provides that the Coal Company shall transfer to the Reading Company, $10,000,000 of cash or current assets, and $25,000,000 of new 4% mortgage bonds. If these items aggregating $35,000,000, are deducted from the net worth of the Coal Company ($103,042,447.47) there remains $68,042,447.47. This amount is the value of the Coal Company property to be distributed by the Reading Company, in return for $5,600,000. If property worth $68,042,447.47 is represented by 1,400,000 shares, each share is worth over $48.

The figures on the 1920 balance sheet for the value of nearly all of the Coal Company's assets appear to be on the basis of the 1896 valuations, with deductions for depletion charges and additions for new property acquired. In 1896, according to representations by the Reading Company made at the time to the New York Stock Exchange, the Coal Company had

> "possession of 102,573 acres of anthracite lands, owned and leased,—almost two-thirds of the entire acreage of the Schuylkill coal field,—stocks and bonds in other coal companies, coal in storage and other property, *all of the estimated value of $95,000,000"* (253 U. S. 26, 46. R. 7-8). (Italics ours.)

The evidence on the trial showed that 40% to 50% of all the coal in the anthracite producing area of Pennsylvania belonged to the Coal Company (R. 6, 262).

The net earnings of the Coal Company for the year 1920 aggregated $6,672,222 (R. 199) and the earnings for

the four preceding years were as follows: 1916, $2,463,790; 1917, $5,436,633; 1918, $4,160,162; 1919, $2,866,736 (R. 199); an average of $4,319,908 per annum over a period of five years. These earnings, after the deduction of $1,000,000 in interest payments which would have to be made upon the $25,000,000 new 4% mortgage bonds to be delivered under the plan (R. 274), would be sufficient to pay an average annual dividend of 59% upon the price ($5,600,000). The earnings for the year 1920 alone (after deducting the $1,000,000 interest charges aforesaid) would be more than sufficient to pay to the holders of the stock of the New Coal Company a dividend of 100% upon an investment of $5,600,000 and the earnings for the four preceding years would (after payment of the interest charges of $1,000,000) be sufficient to pay dividends on an investment of $5,600,000 as follows: 1916, 26%; 1917, 79%; 1918, 56%; 1919, 33%.

The Distribution Reduces the Large Consolidated Surplus and Leaves the Capital Stock Unimpaired.

The Coal Company, rich in net assets though it is, has a net worth less than the accumulated consolidated surplus of the Reading Company and of the Railway Company and the Coal Company, of which latter two companies the Reading Company is sole stockholder. The surplus of the Reading Company, according to the balance sheet of December 31, 1920, was $33,996,983.01 (R. 200); of the Railway Company, $63,706,652.09* (R. 259); of the Coal Company, $25,685,428.48 (R. 198), or a total of $123,389,063.58 (R. 259). The surplus has been accumulated out of earnings from year to year, since the receivership and reorganization of 1896 (R. 259). The distribution of the stock of the Coal Company therefore, *involves no impairment of capital.* Indeed, the Reading

* On the tentative balance sheet (R. 200) this figure was $63,727,325.91.

Company has introduced an exhibit to the effect that, if the proposed plan had been fully consummated on December 31, 1920, and the New Coal Company stock distributed as originally proposed, the Reading Company would still have remaining, a surplus of $54,115,478.43 (R. 200).*

Thus the result of consummation of the transactions involved in the plan is to reduce the consolidated surplus from $123,389,063.58 to $64,115,478.43 (R. 200, 259).

If, however, the balance sheet of the Reading Company alone be regarded, the consummation of the transaction would absorb its large accumulated surplus without impairing its capital stock to any material extent.

Under the plan the Reading Company is to eliminate from its assets the Coal Company's indebtedness to it of $69,357,017.99 and the capital stock of $8,000,000 of the Coal Company—an aggregate of $77,357,017.99.

On the other hand the Reading Company is to receive $40,600,000 as follows:

Cash or current assets from the Coal Company	$10,000,000
New 4% mortgage bonds of the Coal Company (*at par*)	25,000,000
Cash from stockholders of the Reading Company	5,600,000
Total	$40,600,000

Thus if the balance sheet of the Reading Company alone be regarded, its surplus will be reduced by $36,757,017.99 ($77,357,017.99 less $40,600,000). From this, however, should be deducted an item of $2,000,000 in an account called "Philadelphia & Reading Coal and Iron Company Special A/C" by reason of paragraph 3 (R.

* To this amount should be added $10,000,000, as paragraph 4 of the plan originally submitted contemplated a payment of this sum to the holders of the General Mortgage bonds. Upon objection this provision was abandoned.

274) which provides for the exchange of releases of all claims and liabilities as between the Reading Company and the Coal Company,* making the net reduction of surplus $34,757,017.99 involving an immaterial impairment of capital as of December 31, 1920, of less than $760,000, which no doubt is entirely restored by 1921 operations. As previously stated, however, the Reading Company itself records the fact that after consummation of the transactions proposed in the plan, the surplus remaining will be $54,115,478.43 (R. 200).

The Plan Emanates from the Board of Directors.

The plan thus to distribute the assets of the Coal Company or its stock was formulated and presented by the Board of Directors of the Reading Company (R. 148-149).

The answer of the Reading Company states that no part of the plan was adopted without careful consideration, that

> "the Board of Directors of the Reading Company approached the problem from the point of view . . . third, doing justice between existing classes of security holders. The members of the Board of Directors are, and for years have been, for the most part, personally or in a representative capacity, holders of large amounts of stock, preferred or common, or both of the Reading Company . . . It has been the primary concern and guiding principle of the Board of Directors of the Reading Company, during months of anxious consideration, to devise a plan" . . . (R. 154-155).

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* This elimination is made in balance sheet annexed by the Reading Company to its answer as Exhibit G (R. 200).

Control of the Reading Company is in the Preferred Stockholders.

Each share of Reading stock, preferred and common alike, has one vote.*

Of the 2,800,000 shares of stock of the Reading Company, 1,210,300 shares, or about 44% of the total, are owned by the New York Central and the Baltimore & Ohio Railroad Companies alone (R. 140, 142). This was substantially the situation in 1914 (R. 271). Of the 1,210,300 shares held in 1921 by the two railroad companies, 813,200 are preferred (R. 140, 142). Five shareholders, including the Iselin, McKean and Baer interests in 1914, owned 1,256,691 shares or about 45% of the total (R. 271). Of the shares held by the five shareholders mentioned, 848,369 or about 68%, in 1914, were preferred. As the remaining shares are widely scattered (R. 208, 209), the closely held large blocks of preferred stock constitute the dominating interest. The Board of Directors naturally respond thereto.

The proposed plan transfers to the preferred stockholders, not all, but one-half of the New Coal Company stock.

There seems no occasion to question the accuracy of the statement in the Reading Company answer that "to devise" the proposed plan (whereby the New York Central and the Baltimore & Ohio alone upon its effectuation would receive on their preferred shares rights of minimum market value of $10,978,200, or if they disposed of their holdings in the Reading Company, would retain the control of the New Coal Company) was to the members of the Board of Directors a matter of concern "during months of anxious consideration" (R. 155).

* The present Board of Directors, according to Poor's Manual of Railroads, 1921, p. 1677, is as follows: Henry P. McKean, Daniel Willard, H. L. Bond, A. H. Smith, A. H. Harris, Edward T. Stotesbury, Jos. E. Widener, Agnew T. Dice (Pres.) and C. H. Ewing. Of these, Daniel Willard is President of the Baltimore & Ohio Railroad Company and H. L. Bond solicitor for the same (R. 142). It likewise appears from the Manual (p. 1466) that A. H. Smith is President and A. H. Harris Vice President of the New York Central Railroad Company.

The Respective Rights of the Stockholders.

The charter of the corporation throws little light on the respective rights of the stockholders. The Reading Company was created pursuant to an Act of the Legislature of the Commonwealth of Pennsylvania, approved May 24, 1871, under the name of the Excelsior Enterprise Company, and was granted the same powers as the Pennsylvania Company created under an Act of the same Commonwealth, approved April 7, 1870, as supplemented by an Act approved February 18, 1871. Under these Acts, the Company was empowered to issue both common and preferred stock and to sell or dispose of any portion on such terms and conditions as the Company should agree upon with subscribers (R. 54-55).

The acts are set forth *in extenso* in the Record (R. 189-197). Subsequently, the name of the Company was changed and the authorized issue of stock increased (R. 55-56).

The stock certificates now in question are set forth in the record (R. 88-93). The Certificates are printed as Appendix A hereto.

The Certificate for the first preferred stock provides that such stock (italics not in originals)

> is entitled to non-cumulative dividends at the rate of but *not exceeding 4% per annum,* in each and every fiscal year, in preference and priority to any payment in or for such fiscal year, of any dividends on other stock";

that the Board may, out of surplus for any year, declare dividends on second preferred stock

> "after providing for the payment of *full* dividends for any fiscal year on the first preferred stock";

that

> "the Reading Company should have the right at any time to redeem either or both classes of its preferred stock at par in cash".

The Certificate of the second preferred stock provides that it

> "is entitled to non-cumulative dividends at the rate of, but not *exceeding 4% per annum* in each and every fiscal year in preference and priority to any payment in or for such fiscal year, of any dividend on the common stock, but only from undivided net profits of the company remaining after providing for the payment of the *full* dividends for such fiscal year on the first preferred stock";

that on certain conditions, the second preferred stock may be converted one-half into first preferred stock and one-half into common stock; that

> "the Reading Company shall have the right at any time to redeem either or both classes of its preferred stock at par in cash."

The Certificate of the common stock provides that

> "the Reading Company shall have the right at any time to redeem either or both classes of its preferred stock at par in cash"

and that*

> "if from the business of any particular fiscal year, excluding undivided net profits remaining from previous years after providing out of the net profits of such particular fiscal year for the payment of the *full* dividends for such fiscal year on the First and Second Preferred Stock, there shall remain surplus net profits, the Board of Directors may declare, and out of such surplus net profits of such year may pay, dividends upon any other stock of the Company. *But no dividends shall in any year be paid upon any such other stock out of net profits of any previous fiscal year in which the full dividends shall not have been paid on the First and Second Preferred Stock.*"*

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* The same provision is contained in the first preferred and second preferred stock certificates.

The stock certificates are now in the forms adopted pursuant to resolutions of the board of directors on September 14, 1904, in conformity with the rules of the New York Stock Exchange and the Philadelphia Stock Exchange. They are in substantially the same form as originally issued according to the resolution of the stockholders at a special meeting held December 18, 1896 (R. 78-81). The resolution of the stockholders carried out the plan and agreement of re-organization dated December 14, 1895, under which the Reading Company, which had previously been in receivership, was reorganized.

Circumstances Surrounding the Issue of the Preferred and Common Stock.

In 1893 the old Reading Railway Company and the Coal Company went into the hands of receivers, after default in the payment of interest on bonds issued under a mortgage. The receivership continued until 1896, when a scheme of reorganization was promulgated and effectuated. The Reading Company acquired the entire capital stock of the new Railway Company and of the Coal Company. The Coal Company became a co-obligor with the Reading Company on an issue of bonds limited to $135,000,000, and joined in the execution of a mortgage on all its property to secure such bonds (R. 6, 7). Prior to the reorganization there had existed general mortgage bonds, first preference income bonds, second preference income bonds, third preference income bonds, capital stock and deferred income bonds (R. 222). Under the reorganization plan the general mortgage bondholders secured new general mortgage bonds and a small percentage of cash; the first preference income bondholders received for the face value of their claims, 30% in first and 100% in second preferred stock of the new company; the second preference income bondholders received, 65% in second preferred stock and 55% in common stock; the

third preference income bondholders received, 35% in second preferred stock and 85% in common stock. The stockholders and deferred income bondholders of the old company received common stock. The preference income bondholders and stockholders of the old company were required to pay assessments of 20%, the deferred income bondholders 4% (R. 224).

After providing a large amount of the first preferred stock for the reorganization managers and syndicate, some first preferred stock went to the first preference income bondholders; over $40,000,000 of the total authorized issue of $42,000,000 of second preferred stock went to the first, second and third preference income bondholders; while the common stock went to the old stockholders, the second and third preference income bondholders, and the deferred income bondholders (R. 213, 223).

The reorganization plan as submitted by the Reorganization Committee stated that the total annual fixed charges after reorganization, for interest and taxes would amount to about $9,300,000 and that the net earnings for the two years prior to the reorganization had been as follows:

1894	$9,839,971.32
1895, estimated as to November.....	9,624,123.00

(R. 226). For the four years prior to the reorganization, 1893 to 1896 inclusive, the deficit of the railway and coal companies had risen year by year to an accumulated deficit of $6,883,127.94 (R. 259).

Thus, although as stated by the Reorganization Committee at the time,

> "The new fixed charges will be well within the net income of the system even in the past years of extreme depression, . . ."

there was no reasonable prospect that earnings would be sufficient to justify dividends on the common stock of the reorganized company. The common stockholders thus

took the risk. On the other hand the preferred stockholders who had been previously largely creditors, might reasonably be required to be satisfied with payment of their claims at par.

Payment of Dividends by the Reading Company.

The certificates of preferred and common stock have received practical construction by the parties, continuous and uniform for many years.

The consolidated surplus of the three companies increased year by year from $133,293.12 in 1898 to $123,389,063.58 in 1920 (R. 259). This represents yearly accumulations from earnings.

Dividends have been paid as follows: on the first preferred stock from 1900 to date 4%, except in the years 1900 to 1902 when 3% was paid; on the second preferred stock from 1900 to date 4%, except in the years 1900 to 1902 when no dividends were paid and in 1903 only 1½% was paid. On the common stock no dividends were paid until 1905, when 3½% was paid. From 1906 to 1909 4% was paid. From 1910 to 1912 6% was paid. From 1913 to date 8% has been paid (R. 58). Thus, during the last ten years 4% has regularly been paid on first and second preferred and more than 4% on the common. In 1913 when the common stock was placed on an 8% basis the aggregate accumulated surplus was $52,184,737.34 (R. 259).

It appears that during the ten year period in which dividends of more than 4% per annum have been paid upon the common stock, the dividends were duly declared by the board of directors, the acts of the board were duly ratified by the stockholders, information with respect to the amount of dividends thus declared and paid was published in the annual reports to stockholders, knowledge of the amount of dividends thus paid was general throughout the community, and no protest against,

criticism of, or objection to, the payment of such dividends was ever made by any preferred stockholder or anyone else (R. 58, 59). Extract from the minutes of the meetings of the board of directors of the Reading Company held December 8, 1920 and January 18, 1921, declaring dividends are printed in the Record (R. 94, 95).

The Petition of these Intervening Defendants, Holders of Common Stock.

The petition of the Continental Insurance Company and the Fidelity-Phenix Fire Insurance Company of New York, defendants-appellants, was directed largely to the question on which the court below ordered argument as follows:

> (R. 206): "whether such disposition (of Coal Company stock as provided in the plan) confers upon any one class of stockholders of Reading Company any benefit to the prejudice of the legal rights of any other class of stockholders."

The Insurance Companies, common stockholders, charged that the plan conferred upon the preferred stockholders of the Reading Company great pecuniary benefits in derogation of the legal rights of common stockholders. They contended that preferred stockholders were limited according to the basic contracts between the parties, to dividends at a rate not exceeding 4% per annum, that any benefits to stockholders to be distributed by the Reading Company after the preferred received its 4% per annum, must go exclusively to the common stockholders; that the distribution of the Coal Company's stock as provided in the plan left the capital stock of the Reading Company unimpaired; that the distribution of Coal Company's stock as provided in the plan, will come out of surplus and will confer upon the preferred stockholders pecuniary rights vastly in excess of 4% per annum and correspondingly reduce the surplus available for distribution to the common stockholders.

The Answers of the Reading Company and of the Preferred Stockholders.

The common stockholders were answered in the court below by the argument that the transaction involved is a sale, *not* a distribution by way of dividend, hence, cannot be objected to by any stockholder; that the consideration for the sale, though small, is "adequate for the requirements of the Reading Company"* (R. 163); that the transaction involves a dissolution or partial liquidation of the Reading Company's business and that the rights of preferred and common stockholders on dissolution or liquidation are to share equally.

Decision of the District Court Below.

The holding of the District Court as to the precise nature of the transaction is not clear. In one part of the opinion it is stated that the "offending stock" is to be "disposed of" (R. 280). In another place in the opinion it is stated that the disposition is "by sale through the agency of a corporation created under the provisions of this decree" (R. 281). The opinion continues: "It is

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* The Reading Company in its answer does not anywhere allege that the price to be "paid" by the stockholders of the Reading Company for the stock of the New Coal Company is the equivalent of the value of such stock or is an adequate consideration therefor. It alleges:

> "This consideration is less than it is hoped will prove to be the intrinsic value of the coal property. It is, however, a *substantial,* not a *nominal,* consideration and is in the judgment of the Board of Directors of the Reading Company *adequate for the requirements of the Reading Company"* (R. 163).
>
> "In view of the fact that a good part of the anthracite coal fields in the country are actually or potentially on the market, it is believed the coal stock cannot be sold under pressure of the decree in this cause for a sum *as great as its book value* (R. 163)."
>
> "The coal stock is being sold for less than its book value and it is not asserted on behalf of the intervening common stockholders that it can be sold for *as much as* its book value (R. 163, 164)."

a taking by the law of an asset of that company, *a stock asset*" (R. 281) (italics ours). "Indeed it is now disposed of in substantially the same way as the law would dispose of the property of that company were it being dissolved" (R. 281). The opinion then goes on to state that the disposition is not as a dividend nor, indeed, as a sale, but is a distribution of a part of the Reading Company's capital, as follows:

> "Seeing then that this stock is not an earning of the Reading Company to be distributed as a dividend, but is a part of its capital disposed of in this case to qualifying share-holders. . . ." (R. 282).

The Court then holds that all stockholders should share alike

> "on the general equitable principle that equality is equity and on the corporate right of all shareholders in a Pennsylvania corporation to share equally on a disposition of its assets" (R. 282).

Appeal was allowed by the Court below on the filing of a supersedeas bond in the sum of $750,000 (R. 321), an unprecedented sum in view of the contentions so persistently made in support of the plan that the stock of the New Coal Company to be distributed was worth no more than $4 per share, and to be accounted for only on the basis that "rights" to the stock were selling in the market at between $13.50 and $20 per share (R. 128).

Issues in this Court.

The assignment of errors (R. 317-320) raises the following principal issues:

1. Does the distribution of the New Coal Company stock, as provided in the modified plan, to the shareholders of the Reading Company confer on them rights of value?

2. If so, are the preferred stockholders legally entitled to receive such pecuniary benefits?

3. Is the transaction a sale to the stockholders?

4. If it be regarded purely as a sale, is it nevertheless, in derogation of the rights of common stockholders, as being a sale by a majority to a majority for wholly inadequate consideration?

5. Is the distribution of the New Coal Company stock to Reading Stockholders from capital?

6. Is it by way of dissolution or liquidation of the Reading Company?

ARGUMENT.

Introduction.

This is a suit in equity. The bill in equity of the Government was instituted by virtue of the provisions of the Anti-Trust Act of Congress of July 2, 1890, Chapter 647, 26 Stat. 209.

It is now the settled practice of this Court, while framing decrees effectively to dissolve any illegal combination, thereby to work a minimum of damage to existing property rights and no injustice as between various classes of security holders. Thus, in the *Standard Oil* case, the decree provided for distribution ratably to shareholders of "the shares to which they are equitably entitled . . ." (see *United States* v. *Union Pacific Railroad Company*, 226 U. S. 470, 474). The plan in the *Union Pacific* case first proposed assumed that the distribution of Southern Pacific Company's shares would be either by sale or dividend and if by dividend that the distribution would be to such Union Pacific shareholders "entitled to such dividend . . .". 226 U. S. 470, 471.

In accordance with this policy, this Court in the instant case directed ". . . the disposition of the shares of stock and bonds and other property of the various companies held by the Reading Company . . ." (R. 25): the Court below directed a hearing on the question whether the disposition of the Coal Company's stock as proposed was an invasion of the legal rights of any class of stockholders, and directly determined such question after interventions without objections (R. 156) and after hearing.

Equity having once taken jurisdiction of this case, will be governed by three guiding principles:

(*a*) It will look through the forms to the realities of the situation (R. 24).

(*b*) It will not yield its jurisdiction until it has finally determined all the issues involved and settled the rights of all parties concerned. *1 Pomeroy Equity Jurisprudence,* 3rd Ed., Sec. 181; *Oelrichs* v. *Spain,* 15 Wall. 211, 228; *Clarke* v. *White,* 12 Peters, 178, 187; *Hepburn* v. *Dunlop,* 1 Wheat. 179, 197.

(*c*) It will not work an unnecessary deprivation of the rights of any party in interest, and will not permit such deprivation to be effectuated in its name under the guise of a plan to comply with its decree.

In support of the plan it may be contended that the Courts have power to liquidate or wind up the Reading Company and its railway and coal departments, and in so doing to override the respective legal rights of classes of stockholders. It may further be contended that any such deprivation of rights of one class of stockholders to the enrichment of another class is a necessary incident to the exercise of such power.

But whatever may be the power of the Courts to override the rights of classes of stockholders (*Harriman* v. *Northern Securities Company,* 197 U. S. 244), it is clear that no such deprivation or forfeiture was purported or intended to be decreed in this case.

Far from directing or compelling the stockholders to adopt a plan approved by its decree and overriding the respective rights of the classes of stockholders, the Court below directed that

> "the defendants Reading Company, the Railway Company and the Coal Company shall issue calls for meetings of their respective stockholders according to law for the purpose of submitting to the *stockholders for their approval* such action as may be appropriate to carry out the provisions of the modified plan as approved and supplemented by this decree or in connection therewith" (R. 297, par. 5; italics ours).

The decree merely ordered the Reading Company, the Railway Company and the Coal Company to consummate the provisions of the modified plan (R. 291, par. 2).

The mandate of this Court directed a dissolution of the illegal bonds, but further than that it did not disturb the rights of stockholders. That the Court below did not intend by judicial decree or otherwise to interfere with or alter the existing relative rights of preferred and common stockholders is clear from the specific question propounded by it for argument:

> "whether such disposition confers upon any one class of stockholders of the Reading Company any benefit to the prejudice of the *legal* rights of any other class of stockholders." (Italics ours.)

The Court intended to hold and did hold that the disposition of the Coal Company stock as planned does not confer on any one class of stockholders of the Reading Company any benefit to the prejudice of the legal rights of any other class of stockholders.

The correctness of that holding is the issue presented on this appeal.

I.

The substance of the transaction is the distribution to Reading shareholders of valuable property of the Reading Company, leaving its capital stock unimpaired: hence it is a dividend.

In *Stone* v. *United States Envelope Company,* (*Maine*), 111 Atl. 536 (1920), the Board of Directors of a Corporation proposed to sell its stock at $150 per share, to both common and preferred stockholders in proportion to their holdings. The price was materially below the value of the stock sought to be sold. The preferred shares were entitled to cumulative dividends of 7%. On suit by

a common stockholder, the Court enjoined the proposed sale; and held that the transaction constituted a dividend of the difference between $150 per share and the market value. Preferred stockholders having received their 7% were held not entitled thereto.

The doctrine of this case, if adopted, is sufficient to dispose of the instant case.

A similar holding was made in *Russell* v. *American Gas & Electric Company,* 152 App. Div. (N. Y.) 136. There, the plan was to sell common stock at par, to common stockholders only. The market value of the common stock was about $30 above par. A preferred stockholder brought suit to enjoin execution of the plan unless he was permitted to participate. Injunction was denied, on the ground that the preferred stockholder had received his preference dividends and any distribution in excess thereof, *i. e.,* the difference of $30.00 between the market value and the sale price, should go to the holders of the common stock. The Court said:

> (p. 138): "Where a corporation has property in excess of the amount of its capital stock, the excess is surplus which may be divided among the stockholders entitled to share therein, either in money or property. (*Williams* v. *Western Union Telegraph Co.,* 93 N. Y. 162.) As a holder of the preferred stock the plaintiff could claim no interest in such excess. So long as the dividends upon his stock were paid, and the defendant had property equal in value to the amount of its outstanding capital stock, after the payment of its debts, the corporation, if it saw fit to do so, could distribute all the rest of its assets among the holders of its common stock and the plaintiff would have no ground for complaint.
>
> "It is not claimed that the capital stock of the defendant has been impaired, or that it could not legally issue the additional stock at par. That being so, whatever value the stock had above par represented surplus and was available for distribution among the holders of its common stock."

In the instant case, the record shows that the stock of the New Coal Company, which it is planned to distribute to the Reading stockholders, share and share alike, at $4 per share, has a market value materially in excess thereof. As the plan would create in every Reading stockholder a right to receive one-half of an assignable certificate of interest in the New Coal Company stock at $2 per share of Reading stock, and such rights have been selling at from $13.50 to $20.00, the market value of the Coal Company's stock has been between $31.00 ($13.50 × 2 + $4) and $44.00 ($20 × 2 + $4) per share (R. 128; *supra*, p. 6). The market value of the New Coal Company stock is thus 8 to 11 times its "price". The dividend plainly is from $13.50 to $20.00 per share of Reading stock.

The essence of the plan, as in the *Stone* and *Russell* cases, is the distribution to shareholders *pro rata* of the excess which the assignable interests in New Coal Company stock are worth, above $2.00 per share. The minimum benefit to the two largest Reading shareholders, The New York Central and the Baltimore & Ohio Railroad Companies, solely on their preferred stock, would be $10,978,200 (813,200 preferred shares × $13.50). The *Stone* and *Russell* cases are really *a fortiori* cases, for in those cases stock of the corporations themselves was distributed while in the case at bar, it is tangible property owned by the corporation, *i. e.,* stock of the Coal Company. While the issuance in those cases of new stock disturbed the proportionate interest in the management of the corporation which the preferred stockholder theretofore held, in the instant case, however, the distribution of rights to stock in the New Coal Company does not disturb the proportionate interest of the holders of preferred stock in the management of the Reading Company.

The distribution to Reading stockholders of the "rights" to New Coal Company stock is in itself a dividend. Such rights are assignable, salable, easily convertible into cash. Under the cases of *United States* v.

Phellis, Rockefeller v. *United States* and *The New York Trust Co.* v. *Edwards*, # 260, # 535 and # 536, respectively, Oct. Term, 1921, decided November 21, 1921, and discussed later, no one can doubt that the transaction in question amounts to a dividend.

The payment by Reading Company stockholders of $2.00 for each share of stock held by them is no more than a nominal assessment at the time of the dividend. In the *Stone* case, payment of $150 per share, and in the *Russell* case, payment at par by shareholders did not convert that which otherwise was a dividend into something any the less a dividend.

The actual value of the distribution to stockholders by means of New Coal Company stock is more accurately determined perhaps by reference to the Coal Company balance sheet. From this, it appears that the Coal Company properties, after deducting all liabilities, including the $25,000,000 new 4% mortgage bonds and $10,000,000 cash or current assets to be transferred to the Reading Company, are valued at $68,042,447.47 (*supra*, p. 7). Since there are to be 1,400,000 shares, the value of each share must be about $48. On this tangible basis, the dividend is $22 (one share of Reading stock being entitled to ½ share of New Coal Company stock on payment of $2).

The very least that the Reading Company directors can contend the Coal Company is worth is $77,357,017.99, for the Coal Company stock and debt* to the Reading Company are carried at that figure on the Reading Company's books. This figure is taken, of course, prior to the deducting of $35,000,000 to be transferred to the Reading Company. Even at such book figures, however,

* In the court below, a suggestion was made by the Reading Company which was not pressed, that the $69,357,017.99 indebtedness of the Coal Company to the Reading Company was not *bona fide* but a mere book entry. This Court, however, has treated the debt as valid and subsisting (253 U. S. 26; R. 14-15). Interest has been paid by the Coal Company to the Reading Company on the debt in occasional small amounts from 1896 to date (R. 15).

after deducting the $35,000,000, the Coal Company is worth $42,357,017.99, or $30 per share, for 1,400,000 shares. On this basis the dividend is $13 (one share of Reading stock, being entitled to ½ share of stock of the New Coal Company on payment of $2).

However considered and whatever names be indulged in, and howsoever the transaction be colored with other matters, and whether denominated sale, assessment, dissolution or liquidation, the plain fact is that it is planned to give preferred stockholders, by way of distribution of New Coal Company stock, a dividend of from $13.50 minimum market value, to $22. actual value, per share.

This is the essence of the present case. All else is detail. The opposing contentions are largely an effort to confuse, by argument, however plausible, the issue thus presented.

A dividend is a dividend, however circuitous the route.

It is settled law that dividends need not be paid in cash. Dividends may be in the form of property, such as stock or rights to stock. *Williams* v. *Western Union Telegraph Company,* 93 N. Y. 162.

Moreover, it is not essential that the resolution of the board of directors denominate the distribution as "dividend". This was the holding in the *Stone* and *Russell* cases, *supra,* and in the *Phellis* and *Rockefeller* cases. Indeed, the formality of a resolution of the board of directors is not indispensable *City of Allegheny* v. *Pittsburgh, A. & M. P. R. R. Co.,* 179 Pa. 414, 423; *Hartley* v. *Pioneer Iron Works,* 181 N. Y. 73, 79; *Smith* v. *Moore,* 199 Fed. 689, 697; *Grants Pass Hardware Co.* v. *Calvert,* 71 Ore. 103.

As the Court said in *In re Wilson's Estate,* 85 Ore. 604, 618, "A division of profits without the formality of declaring a dividend is equivalent to a dividend". This

language is also found in *Hartley* v. *Pioneer Iron Works*, 181 N. Y. 73, 79.

In *Wilder* v. *Tax Commissioner,* 234 Mass. 470, the Court said:

> (p. 474): "Indeed it is not suggested that the corporation can legally distribute its profits among the joint owners except as a dividend. . . . The word 'dividend' carries no spell with it. While usually in cash, it is not necessarily so but may be issued in the form of stock or notes."

In *Smith* v. *Moore,* 199 Fed. 689, the Court said:

> (p. 697): "So may a court of equity which always looks through the form to the substance of things . . . treat as dividends all amounts received in consequence of the division of profits of a corporate business."

The contention that there is no dividend because the stock of the Coal Company is capital investment is unsound.

It is contended, and the court below held, that the Coal Company's stock "is in no sense an earning of the Reading Company" but is *"a stock asset* which was and has been owned in specie by Reading Company since the Reading reorganization was formed, and which never was earned or could be earned by the Reading Company itself" (R. 281). (Italics ours.)

In point of strict fact, the original Coal stock is not to be distributed. Stock of a new coal company is to be distributed.

The contention then amounts to this: That assets originally contributed on the formation of the company may never be converted into cash or other property and such cash or other property disposed of to stockholders as a dividend, no matter how great the surplus accumulated out of earnings. This is not the law. This Court examined similar contentions in the *Rockefeller* and *The New York Trust Company* cases and found them without merit (*infra,* pp. 37-40).

The contention involves a fundamental misconception of the nature of capital stock, of surplus and of dividends. Capital stock is the amount originally contributed by stockholders which makes up the fund held out to creditors and to the public as the invested capital of the corporation. A corporation is given certain privileges by the State. The state requires, for the protection of the public and of creditors, that the capital stock of a corporation be not impaired by distribution of any part thereof to stockholders without legislative sanction.

Dividends may not be paid which impair capital. Capital may not be distributed to stockholders. A corporation may not purchase its own stock at all in some jurisdictions because it involves a return of capital. In others, a corporation may not purchase its own stock, unless there be a surplus sufficient to pay for the stock. Capital stock may be reduced only where legislative authority therefor exists. So serious a matter is the distribution of capital in any form that many jurisdictions have declared it a criminal offense.

This capital stock has been commonly known in the cases as a "trust fund". So long, however, as this trust fund be not impaired, any property in excess thereof after deducting liabilities may be distributed to stockholders. Such excess is known as "surplus". Dividends may be declared out of surplus.

It matters not how the surplus arises. It may be that the original property making up the trust fund remains in the corporation in specie. It may be, however, that the original property has been converted time and again into other forms. It may be that the original property has been augmented by way of fixed improvements and all cash earnings of the corporation used up in this manner. In such case, the corporation may borrow cash to the extent of the surplus and distribute the borrowings as dividends.

As said in *Williams* v. *Western Union Telegraph*

Company, 93 N. Y. 162, referring to earnings which had become reinvested in the property:

> (p. 192): "It was commingled with other property of the company and used for corporate purposes but it was not beyond the reach of the dividend making powers of the directors. They could reclaim it for division among the stockholders and, if practical, convert it into cash for that purpose. They could borrow money on the basis of it and divide that."

and as said in *Morawetz on Corporations,* 2d Edition, Section 438:

> "It may even be proper to borrow money for the purpose of paying a dividend, provided a surplus would remain after deducting the amounts of the company's capital and indebtedness from the fair value of the assets which it owns."

See also *Alabama Consolidated Coal & Iron Co.* v. *Baltimore Trust Co.,* 197 Fed. 347, 352.

In *Excelsior Water & Mining Co.* v. *Pierce,* 90 Cal. 131, a suit by a corporation against a former director to recover the amount of dividends paid to stockholders on the ground that dividends had not been paid out of surplus, where the plaintiff to support its contention, proved that the corporation had borrowed money to pay the dividends, the court held that the evidence was immaterial and said:

> (p. 143): "A mining company is working its mines at a profit, but discovers that they can be worked to better advantage by constructing a new tunnel; that is to say, it will be wise economy to incur an expense of, say, $100,000 to construct such a tunnel. . . . Clearly, we think the corporation would be justified in incurring a debt to that amount to carry out the object, and that it could go on declaring dividends after providing for the payment of the accruing interest and for the gradual extension of the principal of such debt.

"But suppose, instead of borrowing in advance to meet payments on the tunnel, it makes some payments out of the current profits which its mining operations provide, justly applicable, at its option, to the payment of dividends. . . . Afterwards it borrows money, no more than it might have borrowed originally on account of the tunnel, and out of the money so borrowed, replenishes the fund applicable to dividends. In such a case, the result is precisely the same as if the money had been borrowed sooner and the identical money borrowed, paid out on the tunnel. Nothing has been accomplished beyond what the directors had a right to do, and surely the mode in which it has been done can make no difference."

It is to be noted that the Reading Company stoutly maintains that the distribution will not impair capital (R. 165, 169, *et seq.*, 200), as it must if it comes out of capital. The President of the Reading Company states (R. 201) that after consummation of the transactions contemplated by the plan, the surplus of the Reading Company will be $54,115,478.43 (without including $10,000,000 which prior to the modification of the plan, was to be turned over to the bondholders). The Reading Company directors do not intend to violate the law against impairment of capital (*infra,* p. 76).

Since the fact in this instance and the intention conform, the distribution must come out of "surplus", and we may proceed to the next phase of the contention that there is no dividend.

The "Ploughed Back" Theory Asserted by the Reading Company is Unsound.

The answer of the Reading Company stated:

"The accumulated surplus of the Reading Company has been ploughed back into the property and is not in form available for current dividends (R. 171) . . . the property (railway company) surplus has been ploughed back into the properties and

has become part of its corpus. It has been spent for the enlargement of the plant and for the increase of facilities. It has been so woven into the warp and woof of the structure as to have become an integral part of it" (R. 173).

The contention here is a variation of that just considered. As has been said, it proceeds on a fundamental misconception of the nature of "capital", "surplus" and "dividend". If the contention were sound, it would never be possible to use as a basis for dividends, a single dollar that had been re-invested in the fixed assets.

The decided cases have settled the matter. That by capital is meant the fund or value which the corporation must maintain for the benefit of creditors was early enunicated.

See:

Wood v. *Dummer,* 3 Mas. (U. S.) 308;
Sawyer v. *Hoag,* 17 Wall. 610;
Scovill v. *Thayer,* 105 U. S. 143.

The capital is a constant and not a variable fluctuating from day to day by "ploughing back". As said by MR. JUSTICE SWAYNE in *Farrington* v. *Tennessee,* 95 U. S. 679, 686:

> "The capital stock is the money paid or authorized or required to be paid in as the basis of the business. . . . The amount authorized cannot be increased without proper legal authority. If there be losses which impair it, there can be no formal reduction without the like sanction."

As said in *Canfield* v. *Morristown Fire Association,* 23 N. J. L. 195:

> (p. 196): "The phrase 'capital stock', as employed in acts of incorporation, is never, that I am aware, used to indicate the value of the property of

the company. It is very generally, if not universally used to designate the amount of capital to be contributed by the stockholders for purposes of the corporation. The amount thus contributed constitutes 'capital stock' of the company. The value of the stock may be greatly increased by surplus profits or diminished by losses but the amount of the capital stock remains the same.

"The funds of the company may fluctuate. Its capital stock remains invariable, save by legislative enactment."

See also:

Markle v. *Burgess*, 176 Ind. 25, 27;
Person & Reigel Co. v. *Lipps*, 219 Pa. 99, 109;
Christensen v. *Eno*, 106 N. Y. 97, 100;

It has seemed to us elementary that the assets of a corporation are not ear-marked, part available for dividends and part not, but that the entire corporate assets, however derived, collectively constitute its capital and accumulated profits, any part of which may be distributed to the stockholders subject only to the restriction that assets be retained equal in amount to the liabilities plus the par value of the outstanding shares of stock.

Hubbard v. *Weare*, 79 Iowa, 678, 689;
Williams v. *Western Union Telegraph Co.*, 93 N. Y. 162;
Bassett v. *U. S. Cast Iron Pipe Co.*, 74 N. J. Eq. 668, 674;
Anderson v. *Farmers Loan & Trust Co.*, 241 Fed. 322, 326, 328.
Lubbock v. *British Bank of South America*, L. R. (1892), 2 Ch. Div. 198.

In the *Lubbock* case, a trading company having a paid up capital of £500,000 sold a part of its "undertaking", consisting of a banking business in Brazil. After enter-

ing into various contracts in connection with the transaction and paying certain commissions, the Directors resolved to credit to Profit and Loss account the sum of £205,000 as the amount remaining over and above the paid up capital. Suit was brought by a stockholder to restrain the Directors from dealing with the amount as if it were income, on the ground that the assets sold were part of the capital and profits therefrom involved an accretion to capital. The suit was dismissed. CHITTY, *J.*, said:

> (p. 200): "This is a trading company, and I have before me a balance sheet of 1891, to which I refer by way of illustration, to show how the accounts of such a banking company are kept, and properly kept, in my opinion. I have before me the Defendant company's accounts up to December, 1890. They put down on the one side their liabilities, treating properly the £500,000 which has been subscribed by the shareholders, as a liability, for the purpose of bringing it into account, as against the assets which they put down on the other side. Then on the same liability side they properly put their current liabilities, and certain other liabilities and reserve fund, which the company, according to its constitution, is justified in making, and they add up the total amount of those liabilities. On the other side they put down their assets, and for the purpose of giving information to the shareholders, they divide the assets into certain heads, 'cash at bank', 'bank premises, and managers' residences in Brazil and River Plate', and then they add up the total on that side. . . . Then when the two sides of this account are compared, there is a surplus of £44,000 shewn, which goes, according to the accountant's regular method of keeping accounts, to the liability side, and represents the balance of assets over liabilities. Now what is the result of keeping an account in this form? The capital of the bank is intact and the account shews it, and after providing for the capital, there remains a surplus which rightly goes to the profit and loss account.
>
> "All that the company is required to do, by force

of the Companies' Act of 1862, is to keep its capital intact, and not to pay dividends out of its own capital; in other words to keep that capital for its creditors and any others who may be concerned therein . . .

"I say I have great difficulty in following the first portion of the argument for the plaintiff, because it was said that what was sold was part of the capital of the company, and that what came in over and above the £500,000 was an accretion to capital, therefore it must be kept intact as part of the capital. That has, with great respect to the counsel who put forward this argument, nothing to do with the matter. The sale being an authorized sale, it is immaterial what is the thing sold . . . The capital which has to be regarded for the purpose of the Act of Parliament is the capital according to the Act and not the things, whether houses, goods, boots or shoes, or hats, or whatever it may be for the time being representing the capital, in the sense of being things in which the capital has been laid out."

In *Smith* v. *Dana,* 77 Conn. 543, 553, the Court said:

"The quality and incident of surplus, however invested or employed, are not the same as those of capital within the strict meaning of that word. . . . It is not so of undistributed profits or surplus in any form. . . . The manner of utilization may be changed, investments altered, permanent property sold and turned into cash . . . with no such artificial consequence that the assets so employed change their character as the result of the process. Investment in permanent works does not and ought not to capitalize. . . . Capital of this kind does not bear the perpetual stamp of capital."

In *The New York Trust Company* v. *Edwards* (274 Fed. 952), the Prairie Oil & Gas Company and the Ohio Oil Company each had pipe lines which either had been originally contributed in specie, or had subsequently been "ploughed back" as part of the fixed assets.

It was strenuously contended that the distribution was of capital assets. The opinion by LEARNED HAND, *J.*, to the contrary commenced as follows:

> (274 Fed. 952, 953): "Neither the Prairie Gas & Oil Company nor the Ohio Oil Company for any moment of time owned the pipe line shares as free assets."

The court proceeded:

> (p. 954): ". . . A dividend may be income to the stockholder, though declared out of property which has long since become a part of the economic capital of the corporation. . . . But it makes no difference that it distributes to the stockholder property which is not current profit, but the means of producing current profit."

This Court affirmed that view and held that "the new pipe line company shares were in substance and effect distributed by the oil company to stockholders"; that this constituted "in effect a dividend out of accumulated surplus", and "was in substance and effect, not merely in form, a dividend of profits by the corporation. . . ."

It is plain that whether the pipe lines in those cases, and the coal lands in our case, be regarded as original capital or as "ploughed back", the essence of the transaction as a dividend distribution is not changed.

The Contention that the Distribution of the Coal Company's Stock is Compulsory, hence Not a Dividend, is Unsound.

Such contention was made in the court below. The District Court held that the distribution "is a taking by the law of an asset" (R. 281).

In fact, the mandate of this Court does not require the Coal Company's stock to be distributed to Reading Company preferred stockholders. Disposition of the stock of the Coal Company is directed, but the mandate leaves undisturbed the respective rights of classes of stock-

holders. An easier way of disposition, than that provided in the plan perhaps, would have been sale on the market, either directly by the Reading Company or through a trustee. Stock owned by other corporations, whose holding thereof has been condemned, is being disposed of by *bona fide* sales to persons unconnected with them (R. 298-300). Indeed, if distribution to stockholders is desired, such distribution should be made to those legally entitled thereto. If there be any compulsion in the law, the rights to buy Coal Company's stock should be offered not to the preferred stockholders but exclusively to the common stockholders.

The *Rockefeller* and *The New York Trust Company* cases (*infra*), again furnish an analogy. In those cases, the Act to Regulate Commerce and the Federal Trade Commission Act furnished the occasion for segregation of the pipe line properties and business from the oil company business, and for the distribution of new pipe line company stock; and in those cases, as in the instant case, the beneficiaries contended that the distribution did not constitute a dividend. The contention is without merit.

The Rockefeller and The New York Trust Company Cases Support the View that the Distribution is a Dividend.

This Court in *Rockefeller* v. *United States* and *The New York Trust Company* v. *William H. Edwards*, No. 535 and No. 536, respectively, October Term, 1921, decided November 21, 1921, passed upon the essential nature of the transaction required by the plan in this case. In those cases by reason of apprehended conflict of tribunals invested with power to regulate interstate commerce, separate business enterprises of corporations were transferred to new corporations and the stock delivered in consideration of such transfer by the latter, distributed to the stockholders of the former. The Prairie Pipe Line

Company stock never came into the possession of the transferring corporation, the Prairie Oil & Gas Company, but was delivered directly to the stockholders, just as the stock of the New Coal Company will not, under the plan, come into the possession of the Reading Company, but will be delivered directly to the stockholders of the Reading Company. In that case, as in this case, the stock was distributed by resolution of the transferring corporation which denominated the distribution something other than a dividend. There, as here, a distinct enterprise was transferred to the new corporation, an enterprise which was a part of the assets which contributed substantially to the earnings of the company. The assets transferred were either part of the original capital in specie or had been "ploughed back" out of earnings. There, as in this case, the companies each had a surplus sufficient to cover the value of the property distributed, the distributions left the capital of the companies unimpaired and required no reduction in their outstanding issues of capital stock.

Counsel for the stockholders in that case urged upon this Court in one form or another the contention that the distribution was not in the nature of a dividend, because it was merely the transfer from one corporation to another, having the same stockholders, of physical capital assets constituting a distinct line of business of the former corporation.*

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*In their brief counsel for The New York Trust Company and John D. Rockefeller said:

"We apprehend that in this Court the Government may advance the proposition that * * * those stockholders should, * * * be treated as having received the pipe line properties themselves and a part of the surplus of the oil companies.

* * * it is to pervert the entire nature of the transaction—to convert into a distribution of surplus to stockholders, what was in purpose, in consummation and in result a transfer from one corporation to another of physical capital assets constituting a distinct line of business upon condition that the interest of the stockholders therein should be preserved—to metamorphosize a business readjustment of the ownership of corporate assets into a fictitious dividend.

But this Court held that the distribution was in effect a dividend out of the accumulated surplus. MR. JUSTICE PITNEY writing for the Court, said:

"We deem it to be too plain for dispute that in both cases the new pipe line company shares were in substance and effect distributed by the oil company to its stockholders; as much so in the case of the Kansas company where the new stock went directly from the pipe line company to the stockholders of the oil company, as in the case of the Ohio company where the new stock went from the pipe line company to the oil company and by it was transferred to its stockholders. Looking to the substance of things the difference is unessential. In each case the consideration moved from the oil company in its corporate capacity, the new company's stock issued in exchange for it was distributed among the oil company's stockholders in their individual capacity, and was a substantial fruit of their ownership of stock in the oil company, *in effect a dividend out of the accumulated surplus.*

. . . . . .

It was in substance and effect, not merely in form, *a dividend of profits by the corporation,* . . .". (Italics ours.)

In those cases this Court was confronted by a difficulty which does not exist in this case. In those cases the stockholders of the new companies were also stock-

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The fact that business plant constituting an integral part of the enterprise was transferred cannot be ignored. The reason is, not that a distribution of earnings may be disguised by making it in the form of property instead of cash, but that in the nature of things any distribution by a corporation of all of its property or of a part of its property which constitutes a distinct line of business (or of the proceeds of the disposition thereof) is something more than (something radically different from) a mere distribution of property" (Brief of Counsel, pp. 18, 19).

"* * * If the answer of the Government is that it was to the pipe line companies that the transfer of surplus was made, our reply is, first, that there was no transfer of surplus, that the transfer was of tangible capital business assets which, necessarily reduced, but did not transfer, the surplus" (Brief of Counsel, p. 25).

holders of the old companies; but in the instant case the decree of the Court provides that the corporations shall be free from common domination and control, and that a holder of a certificate of interest in stock of the New Coal Company can obtain such stock only by making an affidavit to the effect that he is not a stockholder of the Reading Company.

Thus the *Rockefeller* and *The New York Trust Company* cases disposed of the following points in the instant case:

(1) There was a distribution of physical so-called "capital" assets. Yet this was held to be a dividend.

(2) There was also what might be called a partial liquidation. Yet this did not have the effect of negativing the dividend.

(3) The board of directors took action but endeavored to denominate the action which they took something other than a dividend. Yet the distribution of Pipe Line Company stock was held to be a dividend.

(4) The court looked through all forms and guises and saw the essential nature of the distribution as a dividend distribution.

A segregation of properties, which have been employed to violate the Sherman Act, is within the doctrine of those cases. Indeed the lower Court which correctly decided *The New York Trust Company* case, regarded a dissolution under the Sherman Anti-Trust Act as analogous in effect to the situation presented in the Prairie Oil and Ohio Oil segregations (274 Fed. 952, 956). What was said of those segregations was intended to apply with equal force to segregations under the Anti-Trust Act.

II.

The distribution of New Coal Company stock confers benefits on the preferred stockholders of the Reading Company in violation of the legal rights of the common stockholders.

1. The rights of the respective parties are determined by the stock certificates.

The basic agreement between the parties, on which their respective rights depend, is embodied in the stock certificates which have been issued. Respective rights of stockholders of various classes may be prescribed by statute, or by the charter of the corporation. In this case, however, the statutes and the charter of the Reading Company are silent on the matter. The Reading Company had full power to issue and stockholders to accept, stock of the kind mutually agreed upon. Stock certificates of definite form were issued and accepted. While many matters such as the uniform course of conduct in the payment of dividends, the resolution of the Board of Directors providing for the issuance of the certificates, and the reorganization plan of December 14, 1895, throw considerable light upon the proper interpretation of the basic agreement, the agreement is embodied within the four corners of the stock certificates and to these certificates we must turn in the first instance.

The certificates were first issued some twenty-five years ago. Another issue of non-cumulative 4% preferred and common stock in practically identical terms was brought out in connection with the reorganization of the Baltimore & Ohio Railroad Company at about the same time. With respect to the Baltimore & Ohio certificates, question soon arose as to the right of the preferred stockholders to share in dividends in excess of the stated 4%. The Court of Appeals of Maryland held in

1901, in *Scott* v. *Baltimore & Ohio Railroad Co.,* 93 Md. 475, 498, as follows:

> "The solution of the question with which we are now dealing must depend therefore, upon the construction to be placed upon the agreement of the parties as expressed in the stock certificates, that must be taken as the embodiment of the contract, and the final expression of the entire measure of the dividend rights of the parties."

The stock certificates in question are set forth in full as Appendix A hereto (R. 88-93). The authorizing resolution of the Board of Directors is in practically identical language (R. 78-81).

As was said in *Scott* v. *B. & O. R. Co., supra:*

> (p. 498): "Evidence of the situation of the parties, the objects and purposes for which the agreement was made, and, in a case like this, when it is important to decide whether the certificate contains the whole agreement, all the agreements and resolutions which preceded and authorized the issue of the stock, may be resorted to, for the purpose, not of altering the contract, but of arriving at the real intention of the parties as expressed in the written contract."

2. Preferred stock is by its terms limited to dividends "not exceeding 4% per annum".

The language in the stock certificate not only of the preferred, but also of the common shares, and in the resolutions of the board of directors could not be more clear in their specific limitations. Beyond 4% per annum, the preferred stock may not go.

3. Dividends "not exceeding 4% per annum" constitute the "full dividends" to preferred stock.

But the Company's resolutions creating these classes of stock and the stock certificates do not rest with the limitation of the preferred stock to dividends "not exceed-

ing 4% per annum". Care is taken to make it clear that this 4% annual dividend is not merely a prior dividend or a preferred dividend. The documents specifically state that the maximum dividend named is the *"full dividend"* on the two classes of preferred stock, and, lest there be any remaining doubt, the creating resolutions in describing the first preferred stock, first set forth the maximum dividend rate on such stock and then refer to the *"full dividend"* on such stock, and emphasize this by referring to *"the full dividends"* on both classes of preferred stock. In describing the second preferred stock, the resolutions are careful to set forth again the maximum dividend rate on such stock, and to refer to *"the full dividends"* payable on both classes of preferred stock. The same emphatic repetition is used in the certificates for both the first and second preferred stock.

The certificates issued for the common stock emphasize to their holders not only that the other classes of stock have a prior right to dividends, but after these *"full dividends"* for the preferred stock have been paid, any other distribution from surplus net profits would go to the common stock. Otherwise the common stock certificates would merely have indicated that the preferred stock was entitled to payment of 4% per annum prior to the payment of any dividend on the common stock. But the Company concluded the matter by indicating in the common stock certificate that the dividend rate of the preferred stock which had priority was also the *"full dividend"* payable to the preferred stock.

4. The terms providing that the preferred stock may be redeemed at par emphasize the limitations of the preferred.

Lest there be any doubt on the question, the resolutions and the certificates specifically provide against any claim by the preferred stock to more than its

par value and such maximum 4% dividends per annum, by reserving to the Reading Company, *"the right at any time to redeem either or both classes of its preferred stock, at par in cash, if such redemption shall then be allowed by law"*. The resolutions make this reservation immediately following the description of the first preferred stock, and repeat this reservation immediately following the description of the second preferred stock.

The limitation of the preferred stock to a realization of its par value was from the very beginning regarded, not merely as a limitation on the preferred stock, but as an asset of the common stock. Although the limitation on the preferred stock was necessarily included in each certificate for preferred shares, it would have been superfluous as a limitation of the preferred stock in the certificates for the common stock, in which it is nevertheless introduced, if it had not been intended to emphasize the fact that the limitation of the preferred stock to a realization of its par value, operated to vest in the common stock all the remaining equity of the property.

5. The practical construction of the contract supports this view.

Were the contracts ambiguous, the practical construction given by the parties would be conclusive against the preferred stockholders.

At no time in the entire history of the Reading Company has it ever paid to the preferred stock any dividend, or made any distribution to the preferred stock, which has yielded that stock more than 4% per annum. For eleven years the Reading Company has declared dividends on the common stock in excess of those paid to the preferred, and in the last eight years of that period the common stock has received dividends twice as large as those paid to the preferred.

This practical construction by the interested parties is doubly significant because, during the eight years when the common stock received 8% and the preferred stock was limited to 4%, all parties were faced by the possibility that the Company might be obliged to make a distribution of some of its assets to at least some of its stockholders. The Government's dissolution suit was instituted in 1913.

In *Niles* v. *Ludlow Valve Mfg. Co.,* 196 Fed. 994, the Court says on page 995:

> "it remains true that when a considerable number of persons raise no objection for many years to a method of interpreting a contract capable of being interpreted in another way, such a silence is a fair argument that the practical construction given to the contract by those who originally entered into it, is strong evidence that what was done was what they meant to have done."

6. The Reorganization Plan of 1895 confirms this view.

Under the reorganization plan, the preferred stock went largely to previous preference income bondholders (R. 221, 222). Thus, it represented debts which, according to their tenor, were not to be paid except out of earnings. The creditors, that is the previous preference income bondholders, no doubt would have deemed themselves fortunate ever to be paid in full the face value of their claims. They were not entitled to more.

Accordingly, no doubt, express provisions were inserted in the stock certificates providing for the redemption at par of the preferred stock. Those who took the common stock, who with others were required to pay a 20% assessment (R. 223), must have had little hope and no expectation of early dividends. Theirs was the risk, and theirs also the chance of possible future rewards.

Since the reorganization plan provided that the preferred stock should go largely to previous creditors, it

was proper to insert certain provisions for their security. It was provided that the stock of the Reading Company should be divided half into preferred and half into common, and it was contemplated that the preferred might be redeemed and also partially converted into common stock. Thus control of the Reading Company by common stockholders was a reasonable possibility. It was contemplated that in future years, the common stockholders having control, might refuse to declare dividends on the preferred, and the preferred stock, being non-cumulative, would have no remedy. To guard against this contingency, express provisions were inserted in the certificates of the common stock as follows:

> "If, from the business of any particular fiscal year, excluding undivided net profits remaining from previous years, after providing out of the net profits of such particular fiscal year for the payment of the *full* dividends for such fiscal year on the First and Second Preferred Stock, there shall remain surplus net profits, the Board of Directors may declare, and out of such surplus net profits of such year may pay, dividends upon any other stock of the Company. *But no dividends shall in any year be paid upon any such other stock out of net profits of any previous fiscal year in which the full dividends shall not have been paid on the First and Second Preferred Stock.*" (Italics ours.)

Coupled with the provisions for redemption of preferred stock, the provisions quoted clearly show that preferred stock under no circumstances should receive more than 4% dividends, and that all surplus above the par value of the preferred stock should go to the common stockholders.

7. The opposing contentions.

It may be contended by opposing counsel that the language of the stock certificates quoted, limits the declaration of dividends to common stockholders to the

particular year immediately following the making of net profits; and that if dividends are not then paid to common stockholders, they may never be declared and paid. No such extraordinary provision, however, appears in the certificates. The language is not that

> no dividends shall in any year be paid upon any such other stock out of net profits of *the preceding* fiscal year

but that

> "no dividends shall in any year be paid upon any such other stock out of net profits of *any* previous fiscal year"—

Furthermore, the quoted language only refers to previous fiscal years

> "in which the *full* dividends shall *not* have been paid on the first and second preferred stock" (R. 93).

Suppose the construction contended for by opposing counsel be correct. Once a fiscal year has passed, no matter how great the earnings in that year, assuming that first and second preferred stockholders received their full 4% dividends for the year, the common stockholders would not be entitled to dividends out of that year. The common stockholders, in order to be protected, would have to strip the company of its entire surplus earnings immediately after being earned. In such case, if the common stockholders obtained control, there would be no reinvestment in improvements, and the company would be in the position in which no conservatively conducted business could afford to be.

8. The authorities support this view.

In *Scott* v. *B. & O. R. Co.,* 93 Md. 475, stock certificates almost precisely the same as those now

under consideration, were in question. The Baltimore & Ohio preferred certificates provided as follows:

> (p. 504): "The holders of preferred stock . . . are entitled to receive in each year, out of the surplus net profits of the company for the current year, such yearly dividend (non-cumulative) as the Board of Directors of said Railroad Company may declare, up to, but not exceeding, four *per centum*, before any dividends shall be set apart or paid upon the common stock."

Preferred stockholders brought suit and contended that they had the right not only to receive the 4% dividend but also to share *pro rata* with the common stockholders, in the distribution of the residue, or to share equally with the holders of the common stock in any part of the net earnings distributable after the payment of the 4% dividend each to common and preferred stockholders. The Court held that the preferred stockholders were limited to the 4% dividend and that any earnings in excess of the 4% preferred dividend could be distributed only to the common stockholders. The Court said, 49 Atl. 330:

> "Why were the words 'not exceeding' thus inserted? What is their significance? If it was only to indicate that the 4 per cent. was the largest amount that could be received before the common stock was entitled to a share of the earnings, the words 'up to' would have been quite sufficient, and the other words would have been surplusage. But we cannot neglect these words . . ."

In the present case the language of the Reading Company certificate is "the First Preferred Stock is entitled to non-cumulative dividends at the rate of, but *not exceeding,* four per cent. per annum. . . ."

If it had been intended that the preferred stock was to be entitled to any share in earnings exceeding 4% and

that the preferred stock was to receive the 4% dividends, only in preference to dividends on the common stock, and that after the 4% dividends on the common stock were paid, the preferred stock was to share with the common stock in further earnings, the purpose would have been clearly and distinctly indicated. The words *"not exceeding four per cent."* as held in the *Baltimore & Ohio* case limit the rights of the preferred stockholders to 4 per cent. *and no more.* As said by the Court in the *Baltimore & Ohio* case:

> "According to the fair meaning of these words, it seems to be clear that a proper construction of them, and the only one that will harmonize them all, is that the preferred stock should be non-cumulative, and should receive 4 per cent. and no more out of net earnings, but should be entitled to receive that before any dividends are set aside for the common stockholders."

In *Stone v. U. S. Envelope Co.* (Maine 1920) 111 Atl. 536, a common stockholder brought a suit to enjoin the carrying into effect of a vote of the Board of Directors to sell certain stock at $150.00 per share to both common and preferred stockholders. It appeared that the price of $150.00 per share was materially below the value of the stock sought to be sold. The preferred shares were entitled to cumulative dividends of 7% and were entitled to preference upon distribution of the assets of the corporation in liquidation. The plaintiff contended that the *"sale"* of stock at less than its value, was in effect a dividend and the preferred stockholders were not entitled to receive any of the benefits therefrom. The injunction issued. The Court said, page 537:

> "Both parties present authorities sustaining their respective contentions. There are two opposing theories, each of which has judicial support. One theory is that the preferred stockholder presumptively yields nothing in compensation for the benefits

which he receives; that he has and holds all the rights of the common shareholder and in addition has his preferential rights.

"Upon this theory the defendant relies, and in support of it cites *Jones* v. *Railroad Co.*, 67 N. H. 234, 30 Atl. 614, 68 Am. St. Rep. 650 (1892), and a series of cases in Pennsylvania, the latest of which, *Englander* v. *Osborne*, 261 Pa. 366, 104 Atl. 614, 6 A. L. R. 800, affirms the earlier decisions."

"The other theory, which we believe to be better and supported by the weight of authority, is that, in receiving the greater security of his preferential rights, the preferred stockholder impliedly agrees to accept such rights in lieu of equal participation.

"The maxim, *'Expressio unius'*, etc., applies to this case and is decisive."

. . . . .

"Independent reasoning as well as what we deem to be the preponderance of authority sustains the plaintiff's position. Words in contracts, as well as in statutes, should ordinarily be construed 'according to the common meaning of the language.' Surely the phrase 'preferred stock' holds out to the ear of the ordinary investor no promise of participation in earnings beyond his preferential dividend. That this is true has been recognized by authorities.

> " 'It is generally assumed that, where preferred shares are given a fixed preferential dividend at a specified rate, that impliedly negatives any right to take any further dividends.' Palmer's Company Precedents (11th Ed.) 814.
>
> " 'Preferential shares and stock are ordinarily spoken of and regarded, and I think properly regarded, as shares or stock which carry a fixed preferential dividend and are not entitled to anything more.' " *Will* v. *United Lankat Plantations Co., supra.*

In *Russell* v. *American Gas & Electric Co.*, 152 App. Div. (N. Y.) 136, the corporation proposed to sell common stock at par to the holders of common stock only.

The market value of the common stock was about $30.00 above par. A preferred stockholder brought suit to restrain the proposed sale unless he, as a holder of preferred stock, could participate ratably. The Court denied the plaintiff's right to an injunction and said (p. 138):

> "Where a corporation has property in excess of the amount of its capital stock, the excess is surplus which may be divided among the stockholders entitled to share therein, either in money or property. (*Williams* v. *Western Union Telegraph Co.*, 93 N. Y. 162.) As a holder of the preferred stock the plaintiff could claim no interest in such excess. So long as the dividends upon his stock were paid, and the defendant had property equal in value to the amount of its outstanding capital stock, after the payment of its debts, the corporation, if it saw fit to do so, could distribute all the rest of its assets among the holders of its common stock and the plaintiff would have no ground for complaint.
>
> "It is not claimed that the capital stock of the defendant has been impaired, or that it could not legally issue the additional stock at par. That being so, whatever value the stock had above par represented surplus and was available for distribution among the holders of its common stock."

In *Equitable Life Assurance Society* v. *Union Pacific R. R. Co.*, 212 N. Y. 360, a preferred stockholder sought to restrain the distribution by the corporation of a large dividend to its common stockholders. The dividend was the result of profit from the sale of securities and from the conversion of bonds into common stock. The preferred stock was entitled to dividends at a rate not exceeding 4% per annum payable out of net profits. The Court denied the injunction.

It is significant that it was conceded that the preferred stockholders received all of the dividends to which they were were entitled under the stock certificates. The preferred stockholders, however, contended that the

money sought to be distributed was an accretion to capital stock in which the preferred stock was entitled to share. As to that contention, the Court says on page 368:

> "Ordinarily the profits made by a corporation on the purchase and sale of property would so clearly belong to a fund applicable to the payment of dividends that there would be no debate about it. . . . One item of profit is not to be differentiated from another by the nature of the transaction which produced it . . . The proposition that these profits because resulting from what was perhaps an unusual transaction are not profits, but are an accretion which belongs to capital, does not seem to have any foundation on which to rest except earnest assertion."

In *Niles* v. *Ludlow Valve Mfg. Co.,* 196 Fed. 994, affd. 202 Fed. 141, the corporation voted a stock dividend to its common stockholders exclusively. The preferred stock was entitled to a fixed dividend of 8% per year. For twenty years dividends of 8% had been declared upon the preferred stock, and almost always at a much higher rate upon the common stock. The preferred stockholders contended that the stock dividend be distributed to preferred stockholders as well as to common stockholders. The Court denied the petition of the preferred stockholders. The Court said on page 143:

> "These (common stockholders) have the burden of administration upon them; if the corporation is unsuccessful, the loss falls upon them; if successful, they receive the benefits. We think that when the preferred stockholders receive a large interest of 8% provided for in the certificate, they receive all to which they are entitled from the income of the corporation."
>
> "The common shareholders bear substantially all the losses of adversity and are entitled to the gains of prosperity. A contract that they should assume

> all the risk with no corresponding advantage should be clearly established. We find nothing in the law or the certificates or in the past action of the corporation to indicate that the preferred was to share equally with the common in the division of the surplus earnings."

In *Keith* v. *Carbon Steel Co.* (not reported, but which is set forth in Appendix B hereto) decided by the District Court of the United States for the Western District of Pennsylvania, May Term, 1917, a preferred stockholder, after receiving the full dividends, sought to enjoin the payment of an additional dividend of 2% to the common stock on the ground that the common stock had already received dividends as great as those received by the preferred. The preferred stockholder contended that the preferred stock should share ratably with the common stockholders. But Orr, *J.*, denied the plaintiff's prayer, saying:

> "If there were no classification of stock, every share of stock would be entitled to an equal share in the distribution of profits. This proposition is Hornbook Law. The holders of the first preferred stock and the holders of the second preferred stock must be deemed to have been unwilling to take the same risks as the holders of the common stock were willing to take. In other words, they were not willing to take their certificates without an *expression* therein of the amount which they were entitled respectively to receive out of the profits. In their contracts with each other and with the common stockholders, and as well with the corporation, they must be deemed to have insisted upon *expressing* the amount which they should receive out of the net profits. We are unable to see why in contracts such as these before us, the *expression* of the amount to be received under the contract should not be deemed to be an *exclusion* from the minds of the parties for any additional amount. . . .
>
> "A certificate of stock does not ordinarily express the share of profits which a stockholder shall receive from the corporation, and therefore, the law *implies*

a term in the agreement that the holder of such certificates shall share equally in the profits set apart by the management for the payment of dividends. There can be no implication, however, where the contract expressly states the percentage which the one contracting party is to receive from another."

In *Will* v. *United Lankat Plantations Co.*, 106 L. T. Rep. (N. S.) 531; reversed on appeal in (1912) 2 Ch. 571 and (1914) A. C. 11, the corporation proposed to distribute profits from a sale of a substantial part of the company's property and business among the common stockholders exclusively. The preferred stockholders were entitled to cumulative preferential dividends of 10%. A preferred stockholder sought a declaration that he was entitled to share equally with the common stock in the net profits after both classes of stock had received a dividend of 10%. The lower court decided in favor of the preferred stockholders, but the decision was reversed in the Court of Appeals and the latter decision was affirmed by the House of Lords. In the Court of Appeals, FARWELL, *J.*, says (1912) 2 Ch. 571, 579:

> "They (the preferred stockholders) treat shares as though they were born into the world equal, and as if a preference is a kind of subsequent attachment to them, but the whole of the attributes of a preferred share are limited and defined on its birth."

In the House of Lords (1914) A. C. 11, 19, Lord Loreburn says:

> "My lords, I have no doubt myself in regard to this particular resolution, that the people who took the preference shares under it knew perfectly well that they were taking shares with a preferential dividend of 10%. I think they would have been rather surprised, although no doubt they would have been gratified, if they had been told that they were about to receive the almost boundless additional advantages which have been held out to them in the arguments we have been hearing. This is really an attempt to add to the terms of the contract by screwing some-

thing out of the articles which the framers of the contract I do not believe ever thought of; at all events they have stated their contract. It speaks for itself upon this particular subject and ought not to be added to."

9. The decisions of the Pennsylvania State Courts are Distinguishable.

The preferred stockholders cite various decisions of the Supreme Court of Pennsylvania including

Englander v. *Osborne,* 261 Pa. 366, 104 Atl. 614 (1918);

Sterling v. *H. F. Watson Company,* 241 Pa. 105, 88 Atl. 297 (1913);

Sternbergh v. *Brock,* 225 Pa. 279, 74 Atl. 166 (1909);

Fidelity Trust Company v. *Lehigh Valley Railroad Company,* 215 Pa. 610, 64 Atl. 829 (1906).

The Pennsylvania cases may be taken as favoring the principle that in the absence of any words of limitation in the certificates, when earnings are in excess of the amount of the dividend to the preferred shareholders, the common stockholders thereafter are entitled to a like dividend and, thereafter, both preferred and common stockholders are entitled to the excess ratably. This doctrine applies, however, only when the preferred stockholders' certificates simply state the preference and contain no words of limitation that the dividend shall be restricted to the amount of the preference.

The Pennsylvania cases are wholly inapplicable to the situation in the case at bar; for the stock certificates constituting the basic agreement in the case at bar plainly state that preferred shareholders shall be entitled to noncumulative dividends at the rate of, *but not exceeding,* 4

per cent. per annum. *This language has never been construed by any Pennsylvania case.*

Furthermore, in none of the Pennsylvania cases was there a continuous uniform practical construction of the contract by the parties, as in the case at bar, to the effect that the preferred was strictly limited to the fixed dividend rate and the common entitled to dividends in excess thereof. Indeed, the Court in *Sternberg* v. *Brock* (*supra*), is careful to point out that there was no such conduct by the parties.

Again, the Pennsylvania courts do not deal with that provision in the certificates in the case at bar, which is of high importance, to the effect that the preferred may be redeemed at par.

The Pennsylvania cases, therefore, are wholly inapplicable to the facts herein. We go further. We submit that the Pennsylvania doctrine is unsound and that the Federal Courts should refuse to follow it.

10. The construction of the stock certificates should be governed not by any peculiar doctrine of Pennsylvania law, but by the general principles of commercial jurisprudence.

Stock certificates, preferred and common, are sold in vast volume throughout the United States.

The term "preferred stock" has acquired a well defined meaning. The Court in the *Stone* case based its decision largely on "the common meaning of the language". It would be most unfortunate for preferred stock to mean one thing in one jurisdiction and another thing in another.

The Federal courts are not bound to follow the decisions of the Pennsylvania courts in the matter at issue in this case, and it will undoubtedly be noted that the issuance of the stock of the Reading Company antedated the Pennsylvania decisions.

In *Kuhn* v. *Fairmont Coal Co.,* 215 U. S. 349, the question was as to the construction of a mine lease. Mr.

JUSTICE HARLAN fully reviewed the entire subject, saying among other things:

"(p. 360): We take it, then, that it is no longer to be questioned that the Federal courts in determining cases before them are to be guided by the following rules: 1. When administering state laws and determining rights accruing under those laws the jurisdiction of the Federal court is an independent one, not subordinate to but coordinate and concurrent with the jurisdiction of the state courts. 2. Where, *before the rights of the parties accrued,* certain rules relating to real estate have been so established by state decisions as to become rules of property and action in the State, those rules are accepted by the Federal court as authoritative declarations of the law of the State. 3. *But where the law of the State has not been thus settled,* it is not only the right but the duty of the Federal court to exercise its own judgment as it also always does when the case before it depends upon the doctrines of commercial law and general jurisprudence. 4. So, when contracts and transactions are entered into and rights have accrued under a particular state of the local decisions, *or when there has been no decision by the state court on the particular question involved,* then the Federal courts properly claim the right to give effect to their own judgment as to what is the law of the state applicable to the case, even where a different view has been expressed by the state court after the rights of parties accrued. But even in such cases, for the sake of comity and to avoid confusion, the Federal court should always lean to an agreement with the state court if the question is balanced with doubt.

The court took care, in *Burgess* v. *Seligman,* to say that the Federal court would not only fail in its duty, but would defeat the object for which the national courts were given jurisdiction of controversies between citizens of different States, if, while leaning to an agreement with the state court, it did not exercise an independent judgment in cases involving principles not settled by previous adjudications.

It would seem that according to those principles,

now firmly established, the duty was upon the Federal court, in the present case, to exercise its independent judgment as to what were the relative rights and obligations of the parties under their written contract."

See also *Beutler* v. *Grand Junction R. R. Co.*, 224 U. S. 85, 88.

The construction of the stock certificates may be said to be analogous to the construction of a will or of a deed. This Court has refused to follow decisions of state courts on the construction of a will (*Lane* v. *Vick,* 3 How. U. S. 464) and of a deed (*Foxcroft* v. *Mallett,* 4 How. U. S. 353, 379).

The matter of construction of stock certificates, however, is not simply one where this Court may not follow the decision of state courts, but according to principles early laid down, the Court has an affirmative duty to exercise its independent judgment.

In *Swift* v. *Tyson,* 16 Pet. 1, it was established that with reference to commercial documents, the true interpretation and effect is not to be found in any decisions of any particular state but in the general principles and doctrines of commercial jurisprudence. The doctrine of *Swift* v. *Tyson* has never been departed from and has always been regarded as following one of the principles upon which the jurisdiction of the Federal courts rests. The actual case was one involving a bill of exchange drawn in one state and accepted in another. The classic language of the court in *Swift* v. *Tyson* was that the Federal courts in construing contracts and other instruments of a commercial nature would follow "the general principles and doctrines of commercial jurisprudence".

The doctrine has been followed in the case of insurance contracts.

Carpenter v. *Providence Washington Insurance Company,* 16 Pet. 495, 511;

Ætna Life Insurance Co. v. *Moore,* 231 U. S. 543.

It has also been applied to a case of stockholders' liability where a Missouri court construed the Missouri statute one way and this court construed it in another way (*Burgess* v. *Seligman,* 107 U. S. 20) and to a similar case in *Clark* v. *Bever,* 139 U. S. 96. In the latter case, stock of an Iowa railway company was issued to a construction company. A judgment creditor of the railway company sought to hold the stockholder on the theory that the stock was not fully paid. An Iowa Statute and the decisions of the highest Iowa court recognized the liability. This Court held the stockholder was not liable and stated:

> "We cannot consistently with our deliberate judgment upon this question of general law accept the decision of the State Court as controlling the determination of the present case."

A certificate of preferred stock is a commercial document; likewise a certificate of common stock. The words have a generally accepted commercial meaning. As said by the Court in *Stone* v. *U. S. Envelope Company, supra.*

> "Surely the phrase 'preferred stock' holds out to the ear of the ordinary investor no promise of participation in earnings beyond his preferential dividend";

and, quoting from *Will* v. *United Lankat Plantations Company, supra,*

> "Preferential shares of stock are ordinarily spoken of and regarded, and I think properly regarded, as shares or stock which carry a fixed preferential dividend and are not entitled to anything more."

On this point it may not be necessary to refer to the decided cases, for the Reading Company seems to admit that the preferred stockholders are limited to 4% dividends. In their answer, they state that though the intervening common stockholders may object to the transaction,

> "they cannot have it treated as a profit, entitling them to exclusive participation *as in the case of dividends from current profits in excess of 4%.*" (R. 164, italics ours.)

III.

The Transaction is Not a Sale.

It has none of the elements of a sale. There has been no attempt to realize the value of the property to be disposed of. There is to be no auction, no offer to the public. The general public is prevented from bidding either for all or any part of the New Coal Company stock. The disparity between the alleged "price" and the value of the New Coal Company stock is too great. The alleged consideration is purely formal. Rather than a consideration for a sale, it is an assessment on a dividend.

We need merely examine the condition of the Coal Company after the payment to the Reading Company of $10,000,000 in cash or current assets at market value, and the delivery of a mortgage for $25,000,000, to conclude that no adequate consideration will be received by the Reading Company for the transfer of the shares of stock of the New Coal Company.

The Coal Company owns or controls more than 45% of the unmined anthracite coal deposits in the United States (R. 6, 262). In addition to an interest in these coal properties (valued on the books of the Company as of December 31, 1920, at $43,183,094.88), the stock of the New Coal Company will represent an interest in improvements and equipment valued at $14,894,210.91, and stocks and bonds of, and loans to, controlled companies valued at $9,920,260.85 (R. 198). After the payment of the $10,000,000 in cash or current assets provided by the plan, the remaining current assets and Liberty Bonds owned by the Coal Company alone will aggregate $25,450,372.21. Against all this, the only substantial obligations of the New Coal Company will be some $6,000,000 in current liabilities and the proposed new mortgage of $25,000,000.

To contend that the stock of the New Coal Company is worth no more than \$4 a share, is to assert that the value of 45% of the unmined anthracite coal deposits in the United States, the improvements made by the Coal Company thereon, and the stocks and bonds of, and loans to, the controlled companies of the Coal Company (subject to an indebtedness of some \$6,000,000) are worth in the aggregate no more than \$5,600,000.* So to contend is also the equivalent of an assertion that the stock of a company whose earnings for the year 1920 alone aggregated \$6,672,222 (R.198) (and against these earnings \$1,000,000 represents the maximum fixed charges upon the property when the new mortgage of \$25,000,000 is delivered) and whose earnings for the four preceding years were \$2,463,790 (1916), \$5,436,633 (1917), \$4,160,-162 (1918), and \$2,866,736 (1919) respectively, is worth no more than \$5,600,000 (*supra*, pp. 7, 8).

The Coal Company never paid a dividend on its stock to the Reading Company. Its earnings have been permitted to accumulate until the surplus of the Coal Company now amounts to \$25,685,428.48 (R. 198).

The net earnings of the Coal Company for the years 1916 to 1920 (after the deduction of \$1,000,000 in interest payments required to be made upon the \$25,000,000 4% mortgage to be delivered to the Reading Company), if distributed, would be sufficient to pay an average annual dividend of 59% upon the price (\$5,600,000) to be "paid" under the plan for the stock of the New Coal Company. *The earnings for the year 1920 alone (after deducting \$1,000,000 interest on the 4% mortgage) if distributed, would be more than sufficient to pay to the holders of the stock of the New Coal Company a dividend of 100% upon*

* The \$25,000,000 of current assets are set off against the mortgage of \$25,000,000 although exact accounting would require that a long term 4% mortgage bond such as that of the New Coal Company, be valued at 80% of the principal amount when the current rate of interest on such investment is, as it is now, at least 6%.

the "investment" of $5,600,000, which the plan provides the stockholders should "pay" for the stock of the New Coal Company; and the earnings for the four preceding years, if distributed, would be sufficient to pay dividends of 26% (1916), 79% (1917), 56% (1918) and *33% (1919).*

We appreciate all of the net earnings could not providently be distributed, those not distributed will be "ploughed back" into the property, which can only enhance its value. We submit that the enormous value of the coal property, and the past large earnings thereon, as compared with the alleged "price" show that no real "sale" is intended, and that the term sale is only used as a cover for something else.

The question is not whether $4 per share to be "paid" for the stock of the New Coal Company is sufficient in law to support a contract, and we do not understand that any contention is made that property of the Reading Company may be distributed, transferred or sold upon a consideration merely sufficient to support a contract at common law. The question is whether $5,600,000 measures the value of the property to be transferred, or under the circumstances the method adopted is merely a subterfuge.

The Reading Company alleges in its cross petition that it will receive $40,600,000 under the proposed plan instead of $5,600,000 for the sale of its interest in the coal properties (R. 163). None of the $35,000,000 to be paid to the Reading Company by the Coal Company, however, will come from the transferees of the stock of the New Coal Company. The $10,000,000 in cash or current assets and the $25,000,000 in the form of a new mortgage are consideration, not for the transfer of stock, but for the assumption by the Reading Company of all the obligations of the Coal Company under the mortgage and for the release of the debt of the Coal Company to the Reading Company.

Much has been said in this controversy of book values, actual values and book figures, and in an attempt to justify the transaction proposed, the Reading Company has presented groupings of figures and commingling of assets (R. 168-171). The effect of the plan is clear; it cannot be obscured by calling upon the arts of the accountant. Bookkeeping has no magic, it creates no assets; it merely records facts as they exist and all the mergers and the bookkeeping consequent thereon cannot add a single ton of coal to the deposits of the Coal Company nor a single ton of rails to the assets of the Railway Company, nor can it reduce the value of the property which is the subject of the litigation.

Book values of properties made twenty-five years ago, as were the values of the coal properties on the books of the Reading Company, are acceptable at this date if the facts approximate the book values. The actual value of the assets in this case approximates the book value, and this Court is justified in taking the book value as the real worth of the assets.

If what the Reading Company really means when it insists so boldly that the transaction constitutes a sale, is that it is a *bona fide* transaction in which the Reading Company receives as much, or about as much, as the stock is worth (R. 163), and that the transaction is so completely a sale that there is no element in it of benefits conferred by way of dividends to any class of stockholders not entitled thereto, this, as we have seen, is contrary to the plain facts.

No good may be accomplished by calling the transaction one name or another. Suppose it be considered a "sale"; the transactions in the *Stone* and *Russell* cases (*supra*, pp. 23, 24) were so denominated. However denominated, and even for the purpose of argument if it be conceded that some element of sale is involved, the essence of the transaction is that large pecuniary benefits are con-

ferred upon preferred stockholders, to which they are not entitled, in derogation of the rights of common stockholders. This essential nature of the transaction cannot be concealed.

The Union Pacific Case.

The Reading Company relies largely on an alleged precedent in the Union Pacific dissolution. That is no precedent, however, for the proposed transaction. The sale of the stock of the Southern Pacific did not result in the impairment of the surplus of the Union Pacific. No claim could there be made that the transaction there resulted in the distribution of the surplus to which the holders of the common stock alone were entitled. But the real difference between the two cases is that between a *bona fide* sale and that which is not. The consideration for the sale of the Southern Pacific shares in the Union Pacific case was adequate.*

That the decree in the *Union Pacific* case would not have warranted the distribution of Southern Pacific shares at any nominal consideration is abundantly shown by the recital in the decree that the subscription price for Southern Pacific stock could be paid in instalments, but that there must be paid "at the option of the sub-

* In fact the price at which the Southern Pacific shares were offered was approximately the market price of Southern Pacific stock at the time. The final decree in the Union Pacific case was entered June 30, 1913. Holders of record, on August 7, 1913, of Union Pacific stock were given the right to purchase their *pro rata* proportion of Southern Pacific shares at $92 per share, or $88 plus accrued dividends. See *N. Y. Commercial & Financial Chronicle* for August 16, 1913. The range of prices for Southern Pacific on the New York Stock Exchange during August, 1913, was from 89⅝ to 94½, or an average of 92-1/16. The range for the last six months of 1913 was from 83 to 95, or an average of 89. The closing quotations for Southern Pacific on the last day of each of the last seven months of 1913, were as follows: 93¼, 91¾, 89⅞, 90⅜, 87, 87¼, and 88¾. The quotations given may be found in the monthly reports of the *N. Y. Commercial & Financial Chronicle* for the year 1913. These facts were stated by intervenors-appellants in their brief in the court below and no objection thereto was made.

scriber $25 per share at the time of subscription and the balance within one year thereafter, with interest on such balance at the rate of 6% per annum". (Decrees and judgments in Federal Anti-Trust Cases, pp. 20-22.)

On the other hand, the Reading Company cannot well deny that it could sell shares of the New Coal Company many times over if they were offered to the public even at prices substantially above $4 per share for the new stock.

Nowhere in its cross petition, does the Reading Company allege that $4 per share is the amount which represents an *adequate* consideration for the sale of a share of stock of the Coal Company, but it alleges "it is a *substantial* not a *nominal consideration* and is in the judgment of the Board of Directors of the Reading Company *adequate for the requirements* of the Reading Company" (R. 163). Does this mean any more than that the sale of the stock at such price will not produce insolvency of the Reading Company or impair its capital stock, and if not, what does it mean? As stockholders, the appellants have the right to have the Reading Company obtain a *quid pro quo* for assets purported to be sold and to demand the judgment of the board of directors, not upon the question of whether the consideration is *"adequate for the requirements of the . . . Company"*, but whether the consideration is adequate as a *quid pro quo* for the assets from which the Reading Company is to be separated. The property of the Reading Company is not entrusted to the board of directors for the purpose of enabling them to *parcel it out* in such manner as they deem advisable *without regard to the rights of the stockholders,* and the board of directors cannot under the guise of meeting the *"requirements"* of the Company, give that which belongs to the common stock, to the preferred stock for a consideration, however substantial, which cannot be claimed to represent the true value of the property to be transferred.

There is no discretion in a board of directors which permits them to clothe a dividend with the form of a sale and thus seek to render action, invalid as a declaration of a dividend, valid as a sale. Discretion must be real, not formal, and the fiduciary obligation imposed upon a director is not properly exercised when property which he, as a director for many years, has declared in the balance sheets published broadcast to be of great value, is turned over not to a purchaser dealing at arm's length and in good faith for a much lesser sum, but to any class of stockholders who neither in law nor in equity is entitled to receive the same. To give to one stockholder what is unlawfully taken from another, does not justify denominating a dividend, a sale.

In short the Union Pacific *was* an actual sale, and the proposed Reading transfer *is not*.

But even if the proposed Reading transaction were technically a sale, it is one wholly different from that undertaken in the *Union Pacific* case. The one was a sale which could not be set aside because it was a *bona fide* sale and for an adequate price. The other, if a sale, is one to which objection can properly be made because it is at a wholly inadequate price (a small fraction of the market price even during the present period of financial and commercial depression) and is not a *bona fide* sale, but rather a transaction which in substance contemplates an actual *distribution* to stockholders.

IV.

Assuming, *arguendo,* that the transaction is a sale it is void because made by a corporation to its controlling stockholders for inadequate consideration.

We shall assume, to meet opposing contentions, that the proposed transaction is a sale. Nevertheless, we submit that it is legally to be condemned.

1. As fiduciaries, the controlling stockholders have the burden to demonstrate that the sale does not deprive the minority of legal rights, and is fair and for adequate consideration.

The doctrine that the majority holds a fiduciary relationship to the minority is well settled. *Southern Pacific R. R. Co.* v. *Bogert,* 250 U. S. 483; *Mason* v. *Pewabic Mining Co.,* 133 U. S. 50; *Wardell* v. *R. R. Co.,* 103 U. S. 651; *Twin-Lick Oil Co.* v. *Marbury,* 91 U. S. 587; *Backus* v. *Brooks,* 195 Fed. 452; *Jones* v. *Missouri Edison Electric Co.,* 144 Fed. 765; *Rothchild* v. *Memphis & C. R. Co.,* 113 Fed. 4; *Mumford* v. *Ecuador Development Co.,* 111 Fed. 639; *Rogers* v. *Nashville C. & St. L. Ry. Co.,* 91 Fed. 299; *Ervin* v. *Oregon Ry. & Navigation Co.,* 27 Fed. 625; *Meeker* v. *Winthrop Iron Co.,* 17 Fed. 48.

The doctrine was stated in *Southern Pacific R. Co.* v. *Bogert,* 250 U. S. 483, as follows:

> (p. 487, 488): "The rule of corporation law and of equity invoked is well settled and has been often applied. The majority has the right to control; but when it does so it occupies a fiduciary relation toward the minority, as much so as the corporation itself or its officers and directors."

In *Backus* v. *Brooks,* 195 Fed. 452, the court phrased it as follows:

> (p. 454): "Courts of equity have no more valuable function than to protect minority stockholders from the frauds of the majority. When majority stockholders dispose of the property of the corporation which they control in such a manner as to deprive the minority of their just rights in it, there is a breach of trust, and a court of equity is the tribune and the only tribune to provide an effective remedy. . . .
>
> The rights of minority stockholders are those which it is peculiarly the duty of a court of equity to protect."

In *Mumford* v. *Ecuador Development Co.,* 111 Fed. 639, majority stockholders transferred valuable assets of

the corporation worth $6,000,000 to another corporation which the majority owned, for 10% of the future profits of the second corporation. The Court deemed the consideration inadequate, and gave the aggrieved minority stockholders appropriate relief. The Court said:

> (p. 643): "Unless it appears that it was made honestly and for an adequate consideration, a court of equity would interpose to prevent such contracts from being used oppressively and in violation of the rights of the minority. It matters not in what form these rights are invaded; it is the business of equity to penetrate through subterfuges and discover the actual transaction stripped of its disguises. If, then, it shall appear, no matter what may be the machinery employed, that the majority have sold the corporate property to themselves for a wholly inadequate consideration, a court of equity will grant relief to the minority who have thus been despoiled of their property."

In *Mason* v. *Pewabic Mining Co.,* 133 U. S. 50, the majority stockholders of a mining corporation authorized the sale of all its property worth $500,000 for $50,000 to a new corporation. The plan provided that the stockholders of the old corporation have the choice of either receiving an equal proportion of stock in the new company or of taking their *pro rata* share of the $50,000 in cash. The prayer of the plaintiff, a minority stockholder, for an injunction restraining the mining company from transferring its property to the new corporation was granted.

In *Jones* v. *Missouri Edison Electric Co.,* 144 Fed. 765, a corporation with $4,000,000 of stock outstanding, one-half preferred and one-half common, had net assets of about $2,600,000. The majority acquired the entire stock of another corporation whose assets were worth $600,000. A plan of consolidation was drawn up whereby the preferred stockholders (the minority) of the first corporation

whose interest in the assets was 8/13ths (including the arrears of dividends) of the entire assets of the first corporation and one-half of the total combined assets of both corporations were to own only 5/32nds of the combined assets of both corporations whereas the common stockholders who owned, prior to its consolidation, only ½ were to own 27/32nds. A preferred stockholder complaining of the appropriation of his assets by the majority, was given relief. The Court said, speaking through Sanborn, *C. J.:*

> (p. 771): "A combination of the holders of a majority or three-fifths of the stock of a corporation, to elect directors, to dictate their acts and the acts of the corporation for the purpose of carrying out a predetermined plan, places the holders of such stock in the shoes of the corporation and constitutes them actual, if not technical, trustees for the holders of the minority of the stock. The devolution of power imposes correlative duty. In a sale of its property, in a consolidation of a corporation with another, in every act and contract of the corporation, which they cause they make themselves trustees and agents of the holders of the minority of the stock because it is only through them that the latter may act or contract regarding the corporate property or preserve or protect their interests in it. Such a majority of the holders of stock owe to the minority, the duty to exercise good faith, care, and diligence to make the property of the corporation in their charge produce the largest possible amount, to protect the interests of the holders of the minority of the stock, and to secure and deliver to them their just proportion of the income and of the proceeds of the property. Any sale of the corporate property to themselves, any disposition by them of the corporation or of its property to deprive the minority holders of their just share of it, or to get gain for themselves at the expense of the holders of the minority of the stock, becomes a breach of duty and of trust which invokes plenary relief from a court of chancery . . ."

If the doctrine that the majority are *trustees* of the minority is strictly followed, an objecting minority stockholder may set aside any sale from the majority to itself. For it is a well-recognized principle that a purchase of a *trust res* by the trustee may be set aside by the *cestui que trust,* even though there be no fraud, and even though the sale may be fair and for an adequate consideration. *Allen* v. *Gillette,* 127 U. S. 589, 593; *Hoyt* v. *Latham,* 143 U. S. 553; *Perry on Trusts,* 6th Edition, Section 129.

Certain it is that the minority stockholder as *cestui que trust* may prevent any proposed sale from the majority to the majority for an inadequate consideration. Great disparity is not required. And the burden is on the controlling stockholders as trustees to show that the consideration is entirely adequate.

In *Meeker* v. *Winthrop Iron Co.,* 17 Fed. 48, where a lease made by a majority stockholder with a corporation was considered, the Court said:

> "The ownership of a majority of the capital stock of a corporation invests the holders thereof with many valuable incidental rights. They may legally control the company's business, prescribe its general policy, make themselves its agents and take reasonable compensation for their services. But, in thus assuming the control they also take upon themselves the correlative duty of diligence and good faith. They cannot lawfully manipulate the company's business in their own interests to the injury of other corporators. Any contract made by them in behalf of their principal with themselves or with another for their personal gain would be voidable at the option of the company. . . . If a majority of stockholders can, in any event and under any circumstances, thus vote away the corporate property to their individual uses,—a question that need not be decided in this case,—they could only do so upon the clearest and most satisfactory evidence of good faith, and for an adequate consideration; and the

> burden of proof is upon the parties thus acting and claiming the enforcement of such a contract. All doubts in relation to adequacy of consideration and good faith ought to be resolved in favor of the principal."

The rule with reference to the fiduciary relation of majority to minority is like that of director to corporation. Only last term, MR. JUSTICE CLARKE, delivering the opinion in *Geddes* v. *Anaconda Copper Mining Co.,* 254 U. S. 590, said:

> (p. 599): "The relation of directors to corporations is of such a fiduciary nature that transactions between boards having common members are regarded as jealously by the law as are personal dealings between a director and his corporation, and where the fairness of such transaction is challenged, the burden is upon those who would maintain them to show their entire fairness, and where a sale is involved, the full adequacy of the consideration. . . . This court has been consistently emphatic in the application of this rule, which, it has declared, is founded in soundest morality and, we now add, in the soundest business policy."

The controlling elements, then, are as follows:

(*a*) There is a body of stockholders which controls the corporation.

(*b*) Assets of the corporation or part thereof, *i. e.*, the trust *res*, are sold to the controlling stockholders.

(*c*) Can the controlling stockholders maintain the strict burden of proof upon them to show

> (1) that the consideration is fully adequate; and
>
> (2) that it is fair to the minority and that the respective rights of the minority are safeguarded?

2. The burden is not sustained by the controlling stockholders in this case.

(*a*) There is a controlling majority, and this consists of the preferred (*supra*, p. 11). Two stockholders alone, the Baltimore & Ohio Railroad and the New York Central Railroad Companies, whose interests are predominantly as preferred stockholders (*supra*, p. 11), control 1,210,300 shares, or approximately 44% of the entire voting power. As the remaining shares are widely scattered (R. 208-209), this clearly constitutes control. *United States* v. *Union Pacific Co.,* 226 U. S. 470.

The fact of control by the preferred in the case at bar is emphasized by the presence on the board of directors of at least four direct nominees, Messrs. Willard, Harris, Smith and Bond (*supra*, p. 11), of the two stockholders named, the Baltimore and Ohio and the New York Central Railroad Companies.

(*b*) The sale is of corporate assets by the majority, to themselves. The answer of the Reading Company admits that the plan was carefully, "anxiously", prepared by the board of directors, who, of course, respond to the controlling majority. And it is clear that the preferred stockholders are to acquire, ex-hypothesis, one-half of the Coal Company stock to be distributed.

(*c*) It seems quite as clear not only that the burden of showing "full adequacy of the consideration" cannot be sustained by the majority, but also that the consideration is wholly inadequate (*supra*, pp. 60-63). It is also clear that the plan unlawfully deprives minority stockholders of their legal rights.

Brief notice may be given to a minor contention made in the court below. It was urged by the Reading Company (R. 164) that if the common stockholders object "to having certificates of interest in the coal property sold to the preferred and common stockholders ratably, the

remedy of the common stockholders is to make a bid or to ask the court to require that the certificates of interest be sold at public sale to the highest bidder". A decisive answer to this contention of the Reading Company is the following language of Mr. Justice Clarke in *Geddes* v. *Anaconda Copper Mining Co., supra:*

> (p. 609): "But the district court, notwithstanding this finding of inadequacy of price, did not set the sale aside, but ordered that the Alice properties should be offered at public auction by a master, and that if no bid should be received for an amount greater than that which the Anaconda Company had agreed to pay, the sale should be confirmed. The offer at public sale was made, no bid was received, and the private sale to the Anaconda Company was thereupon confirmed. . . .
>
> "In this case, from evidence as to the character of the Alice properties, their location and surroundings, and from the opinions of experts, the trial court concluded that the price paid for them was inadequate, and we cannot doubt that from like or other evidence a more trustworthy conclusion could be obtained as to what their value was than would be derived from an offer at a public sale for cash. . . .
>
> ". . . and when the price was found to be inadequate, a decree should have been entered, vacating and setting it aside, as prayed for by the appellants."

But, say the preferred stockholders, the minority are only entitled to share in the "fruits of the sale" (*Southern Pacific Co.* v. *Bogert*, 250 U. S. 488), and if any improper benefits accrue, the common shareholder cannot object for he participates equally. "Equality is equity", say the preferred shareholders.

An unlawful transaction is not purged of illegality because the person injured is offered equal participation in the fruits thereof.

In the case of *Mason* v. *Pewabic Mining Co.* (*supra*, p. 68), it was held no answer to the objecting minority stockholders that they were permitted to share equally in the stock of the new corporation.

The rule, moreover, is not that the minority share in the fruits of the sale and share equally; but that they participate fairly in accordance with their legal rights on the facts in each case. In the present case, since the "sale" of the Coal Company leaves the capital of the Reading Company unimpaired, any "fruits" thereof must go to the common. The preferred is limited to benefits at "not exceeding 4% per annum". If there be any participation in further benefits, it must be among the body of common stockholders alone.

The preferred stockholders if paid their 4% dividends can have no interest in surplus remaining. All such surplus is in equity the property solely of the common stockholders. The majority in the instant case propose to distribute such surplus partly to themselves. Their argument that "equality is equity" is the argument of him who hath no rights to him who hath all—"share equally with me, for equality is equity". Equity seeks justice, however, and justice as administered by the courts requires that the legal rights of parties be enforced.

When all argument appears to fail, the preferred stockholders resort to the maxim that "equality is equity". But equality is equity only where equality is right. Thus in the distribution of the assets of an insolvent, where the right to share is conceded but the extent thereof presents an insoluble problem, justice is achieved by according equality to different classes of creditors. But the Reading Company is not an insolvent and the right of the preferred stock to share in accumulated earnings for years in which the preferred stock received "full" dividends, does not exist.

The unfairness of the proposed sale is further shown by analysis of the position of the preferred and common stock after its consummation. Prior thereto, preferred stock clearly cannot participate in current profits of the Coal business in excess of 4% per annum. Thereafter, the preferred stock, by reason of joint ownership in

one-half the Coal properties and business, participate with the common stock without limit as fully equal owners of the no par value New Coal Company stock.

It may be rejoined that this is a recurrence to arguments already considered, *i. e.,* Points I and II, *supra.* It is not so, however. We now consider the question on the assumption that the transaction is a sale. The preferred contend that all facts and arguments with reference to the rights of the parties under the stock certificates, and with reference to dividends is immaterial, because, they say, the transaction is a sale. We answer that as a sale, the transaction is improper and voidable, because as such, it is an attempt by fiduciaries to obtain an unlawful profit for themselves at the expense of the minority which they cannot accomplish when considered under any other guise.

Furthermore, as has previously been pointed out, even if in the transaction in question, there is involved some element of sale this does not negative the contention of the common stockholders that the transaction in essence is a distribution of large pecuniary benefits to preferred stockholders to which they are not entitled.

V.

The transaction is not a distribution from capital.

The Court below said:

> "Seeing, then, that this stock . . . is a part of its capital disposed of in this case to qualifying shareholders . . . it will be apparent that this decree of equal right to all shareholders, is based, etc. (R. 282)."

The holding concurred with the contention submitted in the answer of the Reading Company that

> "the thing to be sold, the stock of the Coal Company, is a capital asset" (R. 164),

and that the preferred stockholders

> "are subject to no limitation with respect to distribution either of capital or of accumulations of profits which for any reason have become part of the capital or partake of the nature of capital" (R. 174).

The Pennsylvania Laws provide that dividends may not be declared out of capital as follows:

Act of May 23, 1913, Section 1, P. L. (1913), 336:

> "All corporations, heretofore or hereafter incorporated under any special or general law of this Commonwealth may, at any time or times, declare dividends of so much of their net proceeds as shall appear advisable to the directors; such dividends to be paid to the stockholders or their legal representatives at such time after their declaration as the directors may fix; but such dividends shall in no case exceed the amount of the net proceeds actually acquired by the company, so that the capital stock shall never be impaired thereby."

See also Act of April 29, 1874, Section 16, P. L. (1874) 81.

The directors of the Reading Company do not intend to violate the Pennsylvania statutes. There is in fact no distribution of capital. It should be sufficient, to dispose of this matter, to refer to the consolidated balance sheet submitted by the President of the Reading Company, showing that if the transactions originally contemplated by the plan had been fully consummated on December 31, 1920, the corporate surplus of the Reading Company would have been $54,115,478.43 (R. 200).

If it be Assumed, Arguendo, that Distribution from Capital be Involved, the Transaction is Illegal.

If the transaction involves distribution of capital, the capital stock must be correspondingly reduced. The plan provides for no reduction of the capital stock issued.

Either the transaction does not involve impairment of capital, in which case it is idle to consider the rules of law governing a distribution of capital; or, it does involve impairment of capital, in which case it must be disapproved for that reason.

VI.

The transaction is not a distribution by way of dissolution or liquidation.

Nothing can be more clear than that neither the Reading Company nor the Coal Company is being dissolved. Both companies continue in existence—both companies continue to function.

In *Theis* v. *Spokane Falls Gas Light Co.,* 34 Wash. 23, the majority stockholders voted to dissolve the corporation, when a minority stockholder refused to sell his stock to an eastern syndicate. The corporation then voted to sell its entire plant to a new gas company newly incorporated for the purpose. In granting relief, the Court said:

> (p. 30): "A dissolution of a corporation within the contemplation of the law is the death of the corporation. It means disintegration, a separation, a going out of business. But in this case, all the elements of dissolution are wanting."

See also: *Willard* v. *Spartansburg R. R. Co.,* 124 Fed. 796; *Swan Land & Cattle Co. Ltd.* v. *Frank,* 39 Fed. 456; *Brock* v. *Poor,* 216 N. Y. 387.

Pritchard v. *Barnes,* 101 Wis. 86 (holding that even though a corporation ceases to function, has no property, and goes into voluntary liquidation, it is not necessarily dissolved). *Parker* v. *Bethel Hotel Co.,* 96 Tenn. 252; *Harton* v. *Johnston,* 166 Ala. 317.

This court did not order the Reading Company either liquidated or dissolved. It did order the unlawful combination to be dissolved. It decreed a segregation or separation of the elements, the combination of which was not in harmony with the law. Separation, however, of ownership and control of the Coal Company from ownership and control of the Railway Company and of the Reading Company involves neither dissolution nor liquidation of any of the companies.

Something has been said by opposing counsel of partial liquidation. Such terminology, however, cannot cover up a dividend distribution. Every time a dividend is paid to stockholders, there is a "partial liquidation". The principles which apply in such cases are those which apply to dividends and not to liquidation as upon dissolution of a corporation.

There is, however, not even partial liquidation. The Railway Company continues to do business. The Reading Company, instead of being a mere holding company, becomes an actual operating company. The Coal Company, it is hoped, is to become an active operating company, no longer subject to the domination of the directors of the Reading Company.

Conclusion.

The decree of the District Court should be reversed and the cause remanded with directions to enter a decree in conformity with the law and equity of the case.

Alfred A. Cook,
Attorney for Appellants.

Alfred A. Cook,
Frederick F. Greenman,
Robert Szold,
of Counsel.

APPENDIX A.

First Preferred Stock

100 Shares | 100 Shares

Number | Shares 100

Reading Company

Total Present Issue of First Preferred Stock, $28,000,000.

This is to certify, That the owner of One Hundred fully-paid and non-assessable shares, of the par value of Fifty Dollars each, of the first preferred capital stock of the Reading Company, transferable only in person, or by attorney, on the books of the Company in Philadelphia or New York upon surrender of this certificate. The First Preferred Stock is entitled to non-cumulative dividends at the rate of, but not exceeding, four per cent. per annum, in each and every fiscal year, in preference and priority to any payment in or for such fiscal year of any dividend on other stock; but only from undivided net profits of the Company when and as determined by the Board of Directors, and only if and when the Board shall declare dividends therefrom. If, after providing for the payment of full dividends for any fiscal year on the First Preferred Stock, there shall remain any surplus undivided net profits, the Board out of such surplus may declare and pay dividends for such year upon the Second Preferred Stock. If, from the business of any particular fiscal year, excluding undivided net profits remaining from previous years, after providing out of the net profits of such particular fiscal year for the payment

of the full dividends for such fiscal year on the First and Second Preferred Stock, there shall remain surplus net profits, the Board of Directors may declare, and out of such surplus net profits of such year may pay, dividends upon any other stock of the Company. But no dividends shall in any year be paid upon any such other stock out of net profits of any previous fiscal year in which the full dividends shall not have been paid on the First and Second Preferred Stock. Such First Preferred Stock is authorized to the amount of Twenty-eight Million Dollars, and the consent of the holders of a majority of the whole amount of such First Preferred Stock then outstanding, given at a meeting of the stockholders called for that purpose, is necessary to any increase of such authorized amount thereof, as well as to the creation of any mortgage additional to that for $135,000,000 heretofore authorized, except that, at any time after dividends at the rate of four per cent. per annum shall have been paid thereon for two successive years, said First Preferred Stock may be increased, without such consent, to the extent of 420,000 shares for use towards the conversion of the Second Preferred Stock; and, accordingly, this certificate is issued and accepted upon condition that, without further consent from the holder or owner hereof, the Reading Company may so increase and issue its First Preferred Stock. The Reading Company shall have the right at any time to redeem either or both classes of its Preferred Stock, at par in cash, if such redemption shall then be allowed by law. This certificate shall not be valid until signed by the President, or one of the Vice-Presidents, and the Secretary, or Assistant Secretary, of the Reading Company, nor until registered by the Registrar of Transfers in Philadelphia or New York. This certificate is transferable either in Philadelphia or New York.

IN WITNESS WHEREOF, the said Company has caused this certificate to be signed and the corporate seal to be affixed hereto, this day of

....

VICE-PRESIDENT.

....

ASST. SECRETARY.

ENTERED

....

TRANSFER AGENT.

REGISTERED IN PHILADELPHIA

PENNSYLVANIA COMPANY FOR INSURANCES ON LIVES AND GRANTING ANNUITIES,

REGISTRAR OF TRANSFERS

By

....

REGISTRAR

Shares $50 Each

SECOND PREFERRED STOCK

100 SHARES		100 SHARES

NUMBER

SHARES 100

READING COMPANY

TOTAL PRESENT ISSUE OF SECOND PREFERRED STOCK,

$42,000,000.

THIS IS TO CERTIFY, That the owner of ONE HUNDRED fully-paid and non-assessable shares, of the par value of Fifty Dollars each, in the SECOND PREFERRED CAPITAL STOCK of the READING COMPANY, transferable only in person, or by attorney, on the books of the Company in Philadelphia or New York upon surrender of this certificate. The Second Preferred Stock is entitled to non-cumulative dividends, at the rate of, but not exceeding, four per cent. per annum, in each and every fiscal year, in preference and priority to any payment in or for such fiscal year of any dividend on the Common Stock; but only from undivided net profits of the Company remaining after providing for the payment of the full dividends for such fiscal year on the First Preferred Stock, when and as such undivided net profits shall have been determined by the Board of Directors, and only if and when the Board shall declare dividends therefrom. If, from the business of any particular fiscal year, excluding undivided net profits remaining from previous years, after providing out of the net profits of such particular fiscal year for the payment of the full dividends for such fiscal year on the First and Second Preferred Stock, there shall remain surplus net profits, the Board of Directors may declare, and out of such surplus net profits of such year may pay, dividends upon any other stock of the Company. But no dividends shall in any year be paid upon any such

other stock out of net profits of any previous fiscal year in which the full dividends shall not have been paid on the First and Second Preferred Stock. Such Second Preferred Stock is authorized to the amount of Forty-two Million Dollars; and, except as hereinafter stated, the consent of the holders of a majority of the whole amount of such Second Preferred Stock then outstanding, given at a meeting of the stockholders called for that purpose, is necessary to any increase of such authorized amount thereof, or of the First Preferred Stock, as well as to the creation of any mortgage additional to the mortgage of $135,000,000 heretofore authorized. The Reading Company reserves the right, and this certificate is issued and accepted upon condition that at any time after dividends at the rate of four per cent. per annum shall have been paid for two successive years on the First Preferred Stock, the Reading Company, without further consent from the holder or owner hereof, may exercise the right to convert the Second Preferred Stock, not exceeding $42,000,000 at par, one-half into First Preferred Stock and one-half into Common Stock, and accordingly may so increase and issue its First Preferred Stock and its Common Stock to provide for such conversion of the Second Preferred Stock. The Reading Company shall have the right at any time to redeem either or both classes of its Preferred Stock, at par in cash, if such redemption shall then be allowed by law. The Second Preferred Stock is subject to the prior rights of holders of First Preferred Stock at any time outstanding according to the preferences thereof. This certificate shall not be valid until signed by the President, or one of the Vice-Presidents, and the Secretary, or Assistant-Secretary, of the Reading Company, nor until registered by the Registrar of Transfers in Philadelphia or New York. This certificate is transferable either in Philadelphia or New York.

IN WITNESS WHEREOF, the said Company has caused this certificate to be signed and the corporate seal to be affixed hereto, this day of

....
VICE-PRESIDENT.

....
ASST. SECRETARY.

ENTERED

....
TRANSFER AGENT.

REGISTERED IN PHILADELPHIA

PENNSYLVANIA COMPANY FOR INSURANCES ON LIVES AND GRANTING ANNUITIES,

REGISTRAR OF TRANSFERS
By

....
REGISTRAR

Shares $50 Each

COMMON STOCK

100 SHARES			100 SHARES
	NUMBER	SHARES 100	

READING COMPANY.

TOTAL PRESENT ISSUE OF COMMON STOCK, $70,000,000.

THIS IS TO CERTIFY, That   the owner of ONE HUNDRED fully-paid and non-assessable shares, of the par value of Fifty Dollars each, in the COMMON CAPITAL STOCK of the READING COMPANY, transferable only in person, or by attorney, on the books of the Company in Philadelphia or New York upon surrender of this certificate. First Preferred Stock has been authorized to the amount of Twenty-eight Million Dollars, and Second Preferred Stock to the amount of Forty-two Million Dollars; and a Mortgage has been authorized to the amount of $135,000,000, and the consent of the holders of at least a majority of such part of the Common Stock as shall be represented at a meeting of stockholders called for that purpose is necessary to any increase of such authorized amount of First Preferred Stock or Second Preferred Stock, as well as to the creation of any additional mortgage; provided, that without further consent, at any time after dividends at the rate of four per cent. per annum shall have been paid on the First Preferred Stock for two successive years, the Second Preferred Stock, not exceeding $42,000,000, may be converted at par, one-half into First Preferred Stock, and one-half into Common Stock, and that for such purpose and to such extent the Reading Company may increase and issue its First Preferred Stock and its Common Stock. The Reading Company shall have the right at any time to redeem either or both classes of its Preferred Stock, at par in cash, if such redemption shall then be allowed by law. The Common Stock is subject to the prior rights of holders of all classes of Preferred Stock at any time outstanding, according to the

preferences thereof. If, from the business of any particular fiscal year, excluding undivided net profits remaining from previous years, after providing out of the net profits of such particular fiscal year for the payment of the full dividends for such fiscal year on the First and Second Preferred Stock, there shall remain surplus net profits, the Board of Directors may declare, and out of such surplus net profits of such year may pay, dividends upon any other stock of the Company. But no dividends shall in any year be paid upon any such other stock out of net profits of any previous fiscal year in which the full dividends shall not have been paid on the First and Second Preferred Stock. This certificate shall not be valid until signed by the President, or one of the Vice-Presidents, and the Secretary, or Assistant Secretary, of the Reading Company, nor until countersigned by the Transfer Agent and the Registrar. This certificate is transferable either in Philadelphia or New York.

IN WITNESS WHEREOF, the said Company has caused this certificate to be signed, and the corporate seal to be affixed hereto, this day of

....

VICE-PRESIDENT.

....

ASST. SECRETARY.

COUNTERSIGNED

....

TRANSFER AGENT.

REGISTERED

PENNSYLVANIA COMPANY FOR INSURANCES ON LIVES AND GRANTING ANNUITIES,

REGISTRAR OF TRANSFERS

By

....

REGISTRAR

Shares $50 Each

APPENDIX B.

IN THE

DISTRICT COURT OF THE UNITED STATES

FOR THE WESTERN DISTRICT OF PENNSYLVANIA.

HENRIETTA S. KEITH, a citizen of the State of Pennsylvania, Plaintiff, AGAINST CARBON STEEL COMPANY, a corporation of the State of West Virginia, a citizen of said State.	No. 134, May Term, 1917. In Equity.

Opinion.

ORR, *J.*

Plaintiff seeks to restrain the defendant from the payment of a two per cent. dividend to common stockholders. She is the owner of 244 shares of the second preferred stock of the corporation, and by reason of such ownership, she claims to share in the dividend intended to be distributed to the common stockholders.

The defendant corporation is a corporation of the State of West Virginia, was organized in said State on the 9th day of October, 1894, and has its principal office and its only office for the transaction of its business, in the City of Pittsburgh, in this district. It has fully paid up and issued capital stock of $5,000,000. face value divided into 50,000 shares of $100. each, of which 5,000 shares are known as first preferred stock, 15,000 shares as second preferred stock and 30,000 shares as common

stock. Because of this classification of the stock, there must exist certain contractual relationships between the different classes of stockholders of the corporation, so far as the rights of the owners to participate in the profits of the corporation are considered. What such contractual relationships are, we would ordinarily expect to find disclosed in the corporation laws of West Virginia, in the corporate action of the Company and in the certificates issued by the Company to its respective shareholders. The Corporation Laws of West Virginia are not specially helpful. So far as they have been brought to the attention of the Court, the only provision in the laws of West Virginia relating to the subject of the classification of stock, is found in Chapter 53, Section 16 of the West Virginia Code, which is as follows:

> "The stockholders in general meeting may, by resolution, or by-law, provide for or authorize the issuing of preferred stock, on such terms and conditions, and with such regulations respecting the preference to be given to such stock over the other stock in relation to future dividends or otherwise, as they may deem proper, *Provided*, That the maximum capital of the corporation shall not be exceeded and that notice be first published at least once a week for four weeks successively in some newspaper of general circulation in the county wherein the principal office or place of business of the corporation is situated, of the intention to offer such resolution or by-law."

In pursuance of the authority in that section of the law, the stockholders in their first general meeting at which all the stockholders were present, adopted the following resolution:

> "Whereas this corporation has reserved in its articles of association the right to increase its capital stock from $10,000, the amount already subscribed, to $5,000,000.

"Resolved that the capital stock of this corporation be increased $4,990,000. so that the aggregate amount of stock shall be $5,000,000. divided into 50,000 shares of $100. each, of which 5,000 shares shall be first preferred stock entitled to a non-cumulative dividend of 8 per centum per annum, 15,000 shares shall be second preferred stock entitled to a non-cumulative dividend of 6 per centum per annum, and 30,000 shall be common stock, which stock shall be issued on such terms and conditions as the directors of this Company shall direct. And inasmuch as all the stockholders of said corporation are now present, the publication of notice once a week for four successive weeks of an intention to offer a resolution for the increase of the capital stock of this corporation, as provided in Section 16, Chapter 53 of the Code of West Virginia, is hereby waived."

The certificates of stock which were issued in pursuance of said act and said resolution to the several classes of stockholders were as follows respectively:

"First Preferred Stock.

Incorporated under the Laws of West Virginia.

No........ Shares........

Carbon Steel Company

First Preferred Eight Per Cent. Stock

$500,000. Shares $100. each.

This is to certify that
is entitled to shares of $100 each in the capital stock of the Carbon Steel Company denominated 'First Preferred Stock'. Said stock is entitled to dividends at the rate of eight per cent. per annum payable semi-annually, out of the net profits of the company. The said stock is transferable only on the books of the said company by the stockholders in person or by attorney on the surrender of this certificate.

In witness whereof, the said company has caused this certificate to be signed by its President and Secretary.

"SECOND PREFERRED STOCK.

Incorporated under the Laws of West Virginia.

No........ Shares........

CARBON STEEL COMPANY

Second Preferred Six Per Cent. Stock $1,500,000

Shares $100. each.

This is to certify that
is entitled to shares of $100. each in the capital stock of the Carbon Steel Company denominated 'Second Preferred Stock'. The said stock is entitled to dividends at the rate of six per cent. per annum, payable annually out of the net profits of the company. The said stock is transferable only on the books of the said company by the stockholders in person or by attorney on the surrender of this certificate.

IN WITNESS WHEREOF, the said company has caused this certificate to be signed by its President and Secretary.

"COMMON STOCK

Incorporated under the Laws of West Virginia

No........ Shares........

CARBON STEEL COMPANY

Common Stock $3,000,000.

Shares $100. each.

This is to certify that
is entitled to shares of the common stock of the Carbon Steel Company, transferable only on the books of the company in person or by attorney on the surrender of this certificate."

It will be noticed that by the certificate for the first preferred stock, the stockholder is entitled to "dividends at the rate of 8 per cent. per annum payable semi-annually, out of the net profits of the company", and for the second preferred stock that the stockholder is entitled to "dividends at the rate of six per cent. per annum payable annually out of the net profits of the company".

The contention of the plaintiff is that inasmuch as the common stockholders have already, for the current year, received as large a dividend per share upon the stock held by them as the second preferred stockholders have received, that the corporation must distribute all other earnings for the year which are deemed to be payable to stockholders, to the holders of the second preferred as well as to the holders of the common stock, ratably share for share.

The position of the defendant and certain of the common stockholders who have intervened is that inasmuch as the holders of second preferred stock have received six per centum out of the net profits of the company, that they are not entitled to any more for that particular year, but that all profits for that year distributed in dividends in excess of the amounts specified as payable to the first preferred and second preferred stockholders are properly distributable to the holders of the common stock.

We are of the opinion that the contention of the defendant is sound.

If there were no classification of stock, every share of stock would be entitled to an equal share in the distribution of profits. This proposition is Hornbook Law. The holders of the first preferred stock and the holders of the second preferred stock must be deemed to have been unwilling to take the same risks as the holders of the common stock were willing to take. In other words, they were not willing to take their certificates without an *expression* therein of the amount which they were entitled respectively to receive out of the profits. In their contracts with each other and with the common stockholders, and as well with the corporation, they must be deemed to have insisted upon *expressing* the amount which they should receive out of the net profits. We are unable to see why in contracts such as these before us, the *expression* of the amount to be received under the contract should not be deemed to be an *exclusion* from the

minds of the parties for any additional amount. A contract between a corporation and its stockholders is not any more sacred than a contract between any other contractual parties. Where the parties remain silent in some respects, the law may imply many provisions as intended by the parties. A certificate of stock does not ordinarily express the share of profits which a stockholder shall receive from the corporation, and therefore, the law *implies* a term in the agreement that the holder of such certificates shall share equally in the profits set apart by the management for the payment of dividends. There can be no implication, however, where the contract expressly states the percentage which the one contracting party is to receive from another. We recognize that a somewhat similar case in which a different conclusion was reached was before the Supreme Court of Pennsylvania in *Sternberg* vs. *Brock*, 225 Pa 279, and have felt some hesitation in reaching the conclusion herein expressed. The position, however, taken by this Court, is that taken by the United States Circuit Court of Appeals of the Second Circuit in *Niles* vs. *Ludlow Valve Manufacturing Co.*, 202 Fed. Rep. 141, and if we doubted the correctness of our own conclusions, comity would suggest the propriety of following that decision. The case of *Scott* vs. *B. & O. R. R. Co.*, 93 Maryland, 475, is helpful, and also the English case of *Will* vs. *United Lankat Plantations Co.*, reported in the Court below in 106 Law Times Rep. 531, in the Court of Appeals in 107 Law Times Rep. 360, and the House of Lords in 83 Law Journal Chanc. 195 (1914).

Without commenting upon other matters raised by the defendant in opposition to the motion for an injunction, some of which are interesting and may be sound, we content ourselves with the foregoing limited expression of our views on the main question.

The motion for a preliminary injunction must be refused.